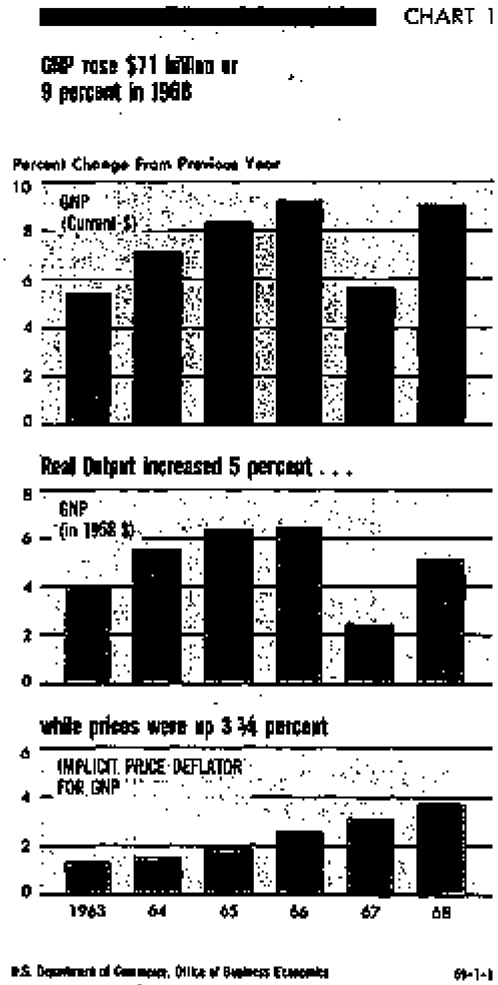
The U.S. Economy in 1968

INCREASED demands in all principal markets brought substantial rises in the Nation's income and production in 1968. It was the eighth year of the long cyclical upswing that started in early 1961 and that was interrupted briefly in early 1967. Employment rose to its highest level ever, and the unemployment rate fell to its lowest level in 15 years. Lower unemployment rates were widespread; even so, they were still considerably above average for those groups at a disadvantage in the labor market, notably nonwhite persons and teenagers.

The problem of inflation continued to be of major concern in 1968, as it has ever since the step-up in the war in Vietnam in 1965. In an economy operating at full employment, the increased demands of 1968 led to sharp increases in costs of production, profit margins, and prices. With demand strong and the supply of experienced labor very scarce, employees were able to win the largest wage increases since the early 1950's. Last year's increase in production was accompanied by some acceleration in the growth of productivity, which had slowed down the year before. However, the productivity rise fell short of the increase in wage rates so that labor costs per unit of production, although rising somewhat less than in 1967, increased considerably. The price rise of 1968 reflected not only these and other cost increases but also expanded profit margins, which had contracted in 1967. Wholesale industrial prices continued to increase, and consumer prices, rising steadily through the year, scored their largest advance in 17 years. Inflationary pressures were accentuated by last year's rise in farm prices, which had fallen in 1967.

Personal income registered a sharp gain in 1968, and notwithstanding the tax increases imposed during the year as well as the continuing price rise, per capita income advanced. In addition, before-tax profits of corporations were much higher than the 1966 peak; after-tax earnings equaled their 1966 high.



Farm income rose but was still short of the 1966 record.

In its transactions with foreign countries, the record for 1968 was a mixed one. The balance of payments deficit, after a sharp increase in 1967, improved in 1968. Aside from some special transactions, this improvement reflected a shift in private capital transactions, from sizable net outflows to a small net inflow, chiefly because foreigners made unusually heavy purchases of U.S. stocks and bonds. However, the balance on merchandise trade, which had been substantial through most of the 1960's, fell precipitously.

Policy problems

Both fiscal and monetary policies were used last year in efforts to stem the expansion and thereby the inflationary tide. The President called for a surtax on individual and corporate incomes in August 1967, but it was not until the end of June 1968 that the surtax was passed, as part of a fiscal program that also included a ceiling on Federal expenditures in fiscal 1969, an extension of certain excise taxes, and limitations on Federal employment. Consequently, in the first half of 1968, the responsibility for curbing the expansion fell on monetary policy. The Federal Reserve followed a policy that provided a limited accommodation to burgeoning credit demands but still permitted a sizable expansion in credit. This policy had some impact insofar as it contributed to the sharp increases in interest rates and braked an ongoing recovery in residential construction. However, monetary restraints were eased once the fiscal program was passed because of the widely shared belief that the expansion in consumer and business spending would slow down and consequently diminish the need for monetary limitations.

This diagnosis proved to be only partially correct since consumer expenditures rose very sharply in the summer. In the fourth quarter, however, spending rose at a much more subdued rate. Private investment demand, far from slowing down, began to accelerate toward the end of the year. It was around this time that the Federal Reserve moved back toward a more restrictive policy, and against a background of heavy demands for credit, market interest rates exceeded their spring peaks, which had been the highest in many decades.

Fourth Quarter GNP and Yearend Position

Output continued to rise at a rapid pace in the fourth quarter. According to preliminary and incomplete data, the GNP advanced $16.8 billion to a seasonally adjusted annual rate of $887.8 billion; this was almost as large as the $18 billion increase the quarter before. The 2 percent rise in the fourth quarter was divided about equally between an increase in physical volume and an increase in price.

The composition of the fourth quarter output gain was quite different from that of the third, even though the two quarterly changes were roughly the same in size. The increase in final sales slowed down, from $21.4 billion to $14.3 billion, while inventory investment increased after a decline in the preceding quarter.

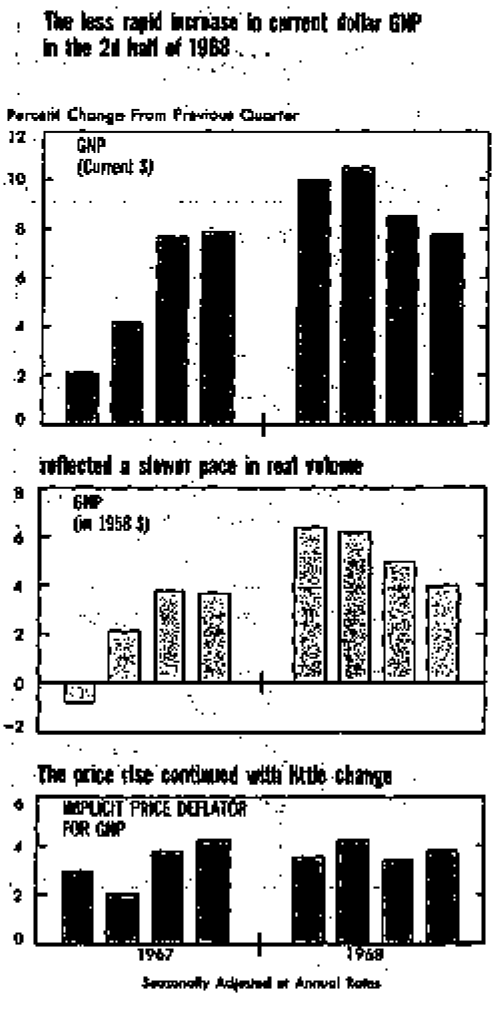
The slower rate of expansion in final sales was attributable to consumption expenditures, which rose only $5 billion after a gain of $13 billion in the third quarter; the rise was the smallest in more than a year. Consumer purchases of autos and parts leveled off after an unusual spurt from the spring to the summer months, while expenditures on household durables declined after seven quarterly increases. Nondurable expenditures showed little gain, but services continued their steady upward movement.

With the rise in consumption much less than the $10 billion rise in disposable income, personal saving increased, and the saving rate advanced almost to 7 percent from 6¼ percent in the third quarter. In the first half, the saving rate averaged 7.3 percent.

Fixed investment was very strong in the fourth quarter. With housing starts recovering from the spring slump and attaining their best level of the year in the fall, residential contruction rose $2.3 billion for the largest gain of 1968. More impressive was the rise in nonresidential fixed investment, which advanced $4 billion after a $3 billion rise the quarter before; most of the increase was for equipment, but an advance was also recorded in outlays for structures, for which spending had been very sluggish during the year.

On the basis of figures for October and November it appears that inventory investment rose from a seasonally adjusted annual rate of $7½ billion in the third quarter to $10.0 billion in the fourth—a gain of $2½ billion. From the second to the third quarter, inventory investment declined $3 billion. The rise in the rate of accumulation appears to be related primarily to the slower expansion in consumer buying, since trade firms accounted for the increase in accumulation.

CHART 2



State and local government purchases continued their steady upward trend with a $2½ billion rise, but Federal outlays recorded their smallest increase since 1965 with an advance of only $½ billion. Incomplete data indicate that net exports were little changed in the fourth quarter—above the abnormally low first half rate but considerably under the 1967 total.

December business

Production, employment and income rose through the quarter and, if anything, appeared to be rising more rapidly at the end than at the beginning. Personal income advanced a large $5½ billion (annual rate) in December, as compared with gains of $3½ billion in October and $4.8 billion in November. The rise in payrolls was especially strong, reflecting a very substantial increase in employment (266,000 in nonfarm establishments), a slight pickup in hours (after decreases in October and November), and continued advances in hourly earnings. Unemployment remained at the post-Korean low attained the month before. Industrial production rose 1 percent, the second consecutive sizable monthly increase.

Final sales in December were much less buoyant than production to judge from partial data. Retail sales, which had shown no growth from September to November, fell sharply in the closing month of the year, according to advance reports. The outbreak of the influenza epidemic in December undoubtedly had an adverse effect on December sales but how much it is impossible to say at this time. There was no evidence of any lessening in the price rise as wholesale prices of industrial commodities advanced again.

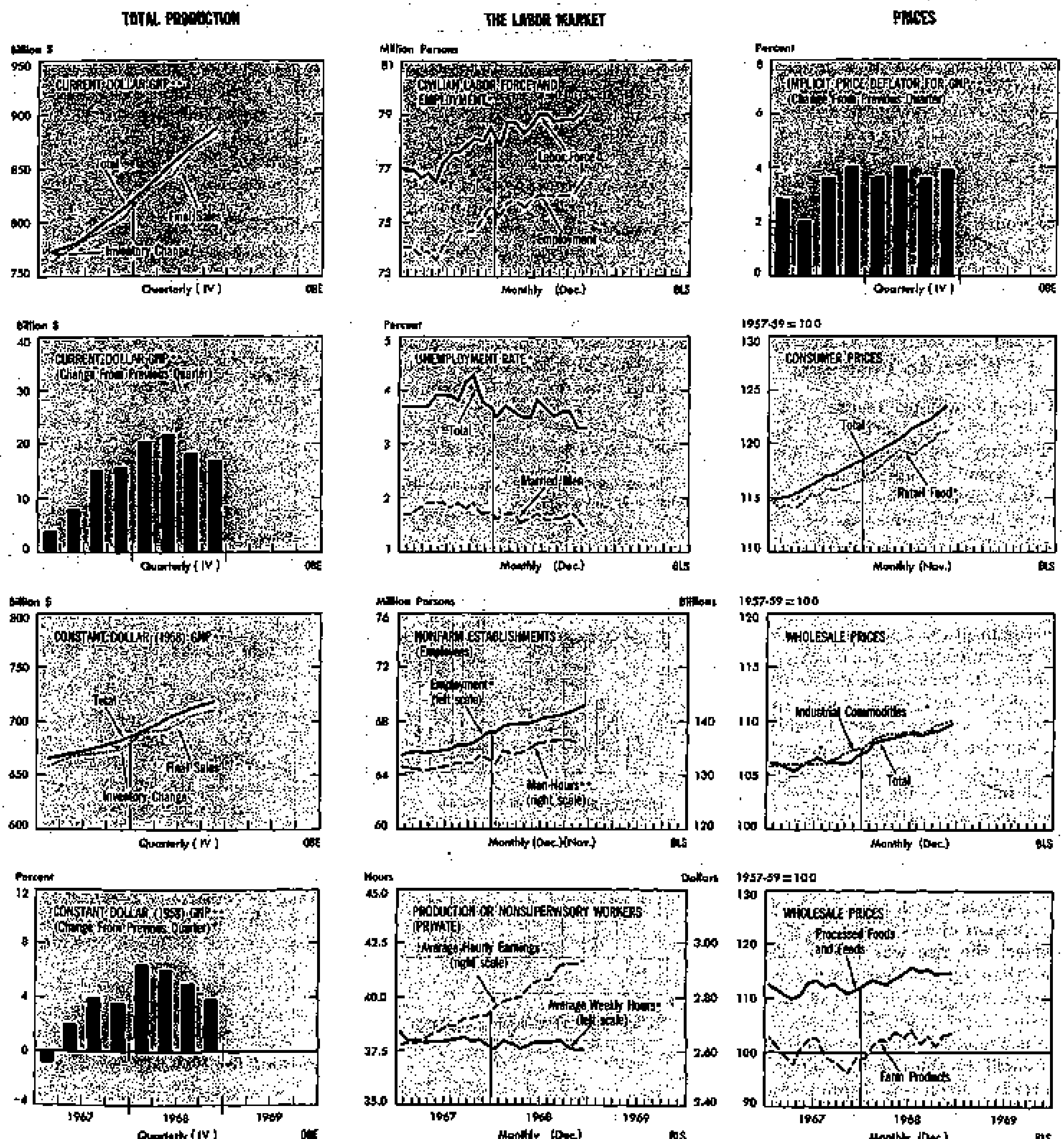
Outlook for 1969

The uncertainties concerning the outlook appear manifold at the start of 1969: Of overriding importance is the course of developments relating to Vietnam, but economic events may also

(Continued on page 38)

CHART 3

- GNP rose $16.8 billion in the fourth quarter; real GNP up 4 percent (annual rate)
- Establishment employment showed another large gain in December—unemployment rate remained at November low point
- GNP deflator continued its steady rise in the fourth quarter—wholesale prices up again in December

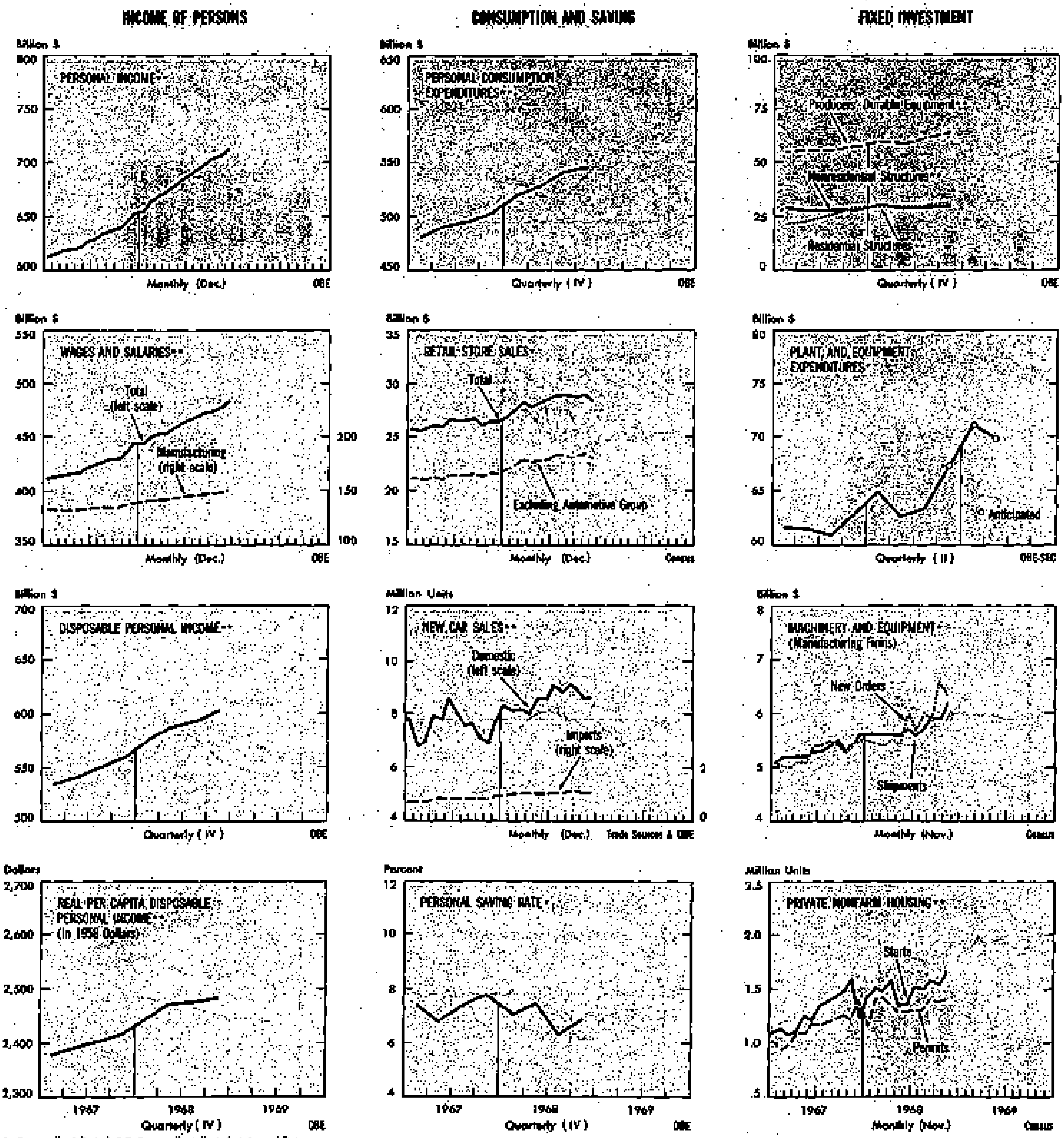


* Seasonally Adjusted ** Seasonally Adjusted at Annual Rates

U.S. Department of Commerce, Office of Business Economics

CHART 4

- Personal income increased 5 ½ billion in December—well above the October-November average gain
- The consumption advance slowed down in the fourth quarter after strong rise in the third—saving rate rebounded
- Nonresidential fixed investment advanced sharply in the fourth quarter—November housing starts were the highest since early 1964



* Seasonally Adjusted ** Seasonally Adjusted at Annual Rates

U.S. Department of Commerce, Office of Business Economics

CHART 5

- In the fourth quarter: Inventory investment increased $2.5 billion over third quarter rate
- Net exports remained at relatively low third quarter rate
- Federal outlays changed little—State and local purchases continued upward

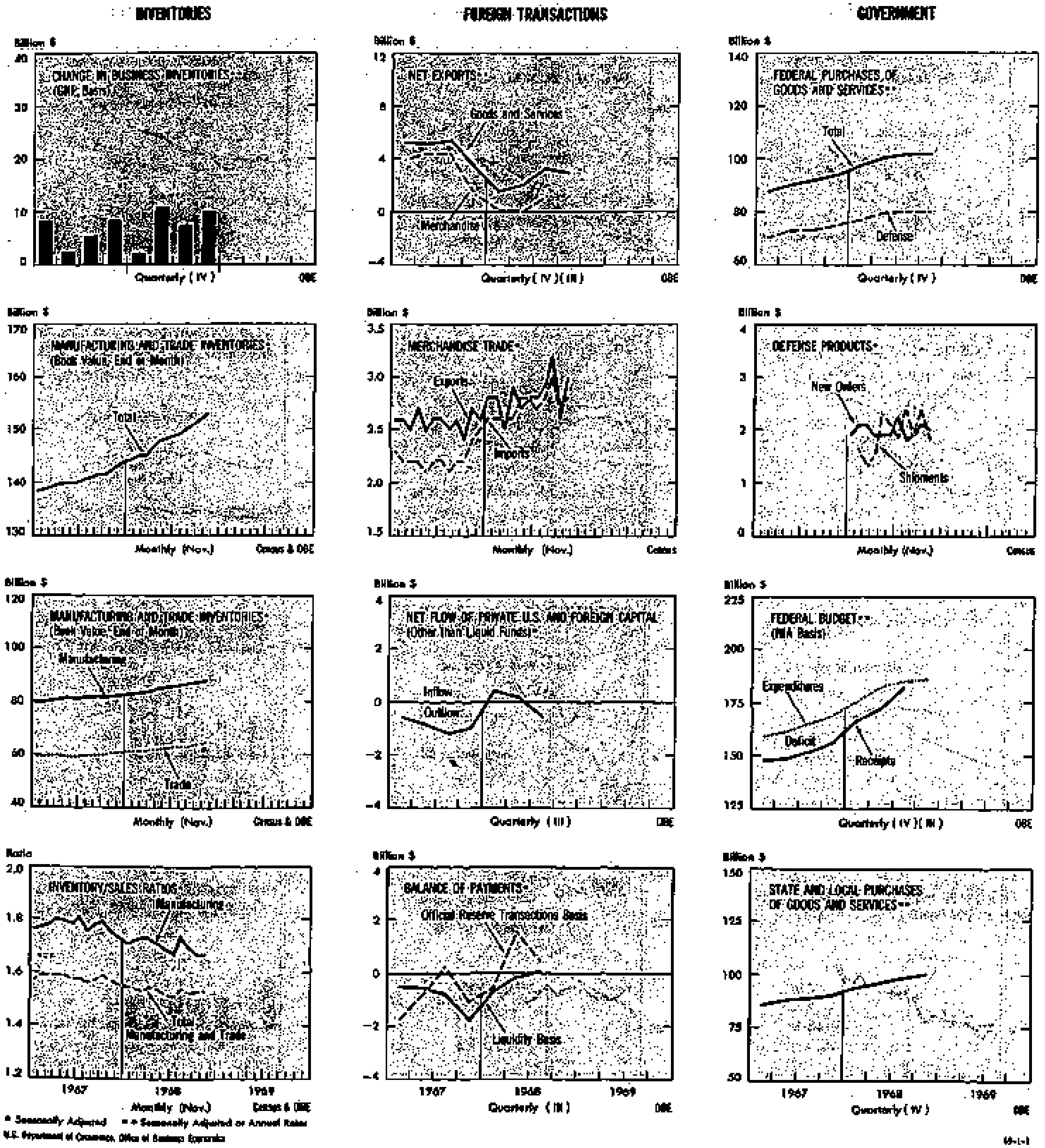
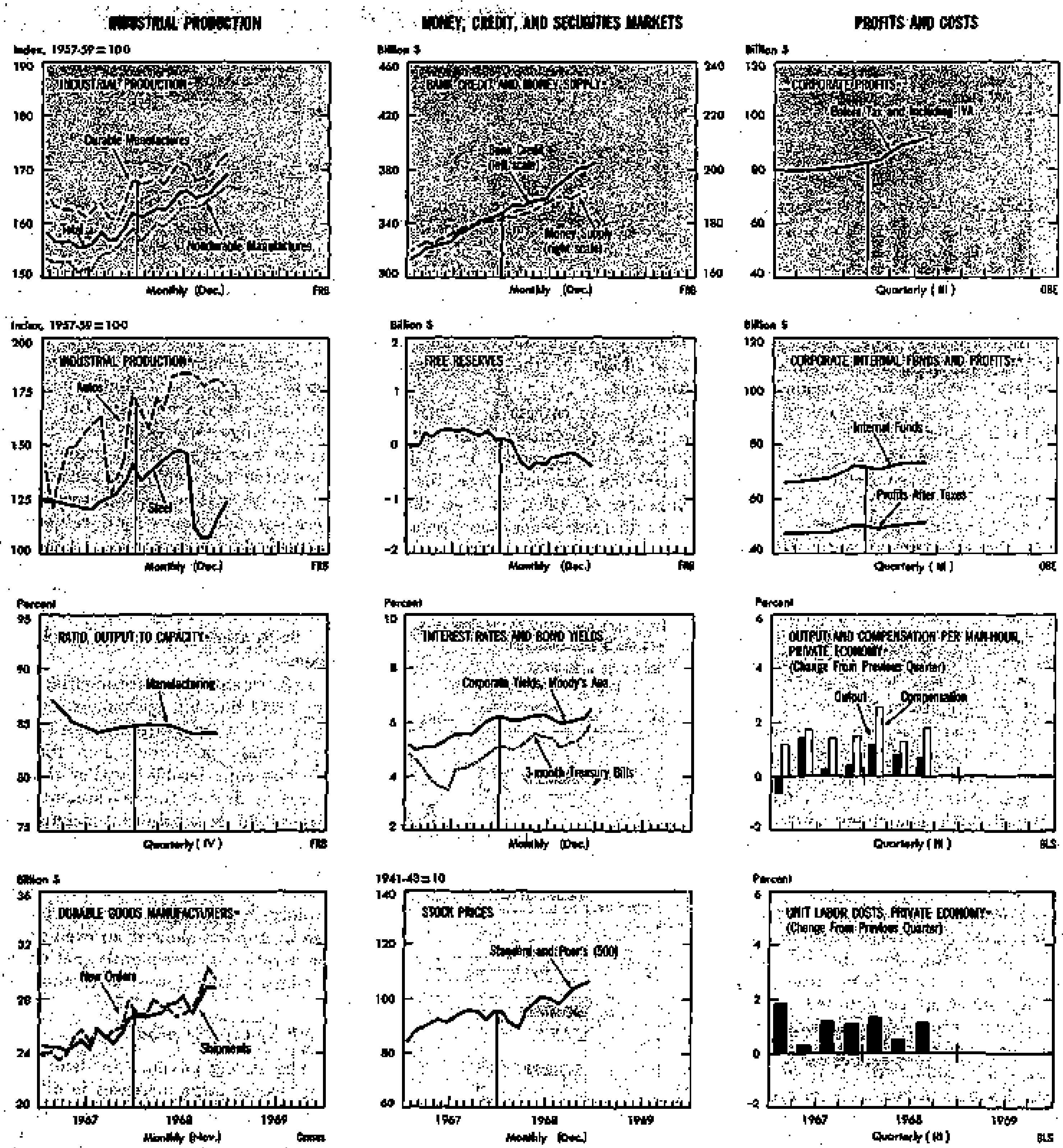


CHART 6

- Industrial production advanced in December for third straight month
- Money supply and bank credit increased again in December
- Interest rates and bond yields rose to new highs



* Seasonally Adjusted ** Seasonally Adjusted at Annual Rates

U.S. Department of Commerce, Office of Business Economics

69-1-6

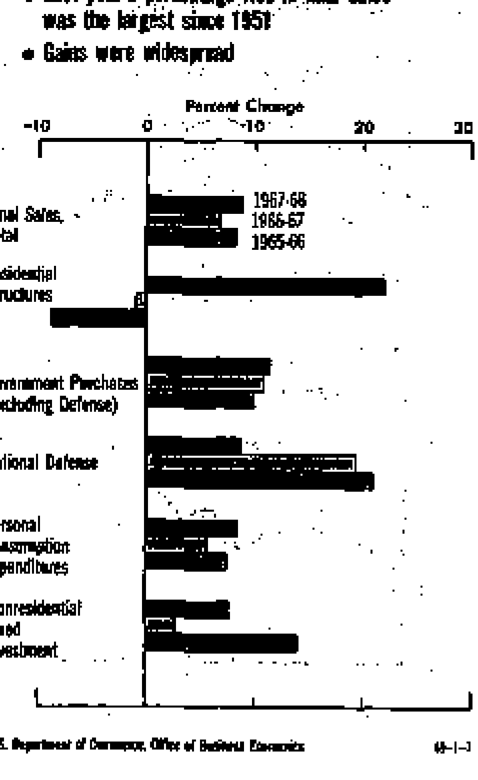
Production and Income in 1968

SUBSTANTIAL increases throughout the year brought the Nation's production of goods and services to a total of $861 billion in 1968, a rise of $71 billion or 9 percent over 1967. This was a considerable step-up over the 5¾ percent increase in 1967, and about matched the large increase in 1966, when the demands for Vietnam were added to an economy operating at a high rate. Consumption and fixed investment were chiefly responsible for the more rapid advance in 1968 than in 1967.

Of last year's rise in current dollar GNP, about 5 percent represented an increase in physical volume, and 3¾ percent, higher prices. The advance in physical volume, although double the gain for 1967, fell short of the full-year rises for both 1965 and 1966. Within the year, the rise in real output was at an annual rate of 6½ percent from the fourth quarter of 1967 to the second quarter of 1968 but tapered to a 4½ percent rate in the following half-year. The price rise continued through the year with little abatement and was a considerable acceleration over the rises of 2.6 to 3.1 percent in 1966 and 1967.

With demand rising in all major markets last year, final sales recorded their largest percentage advance since 1951—9 percent. For the full year, inventory accumulation rose only slightly and thus contributed little to the rise in production. During 1968, however, changes in inventory investment were pronounced. For the most part, this was because the rate of expansion in final sales was very erratic, while changes in GNP, although larger in the first half than in the second, were comparatively steady from quarter to quarter. Final sales, after a modest gain in the last quarter of 1967, recorded an extraordinary advance in the opening quarter of 1968, grew much more slowly in the spring, accelerated noticeably in the summer, and again slowed down in the closing quarter of the year.

Of the main categories of final sales, the largest percentage gain last year (22 percent) was scored by residential construction, recovering from the credit stringency of 1966; it was the first annual increase since 1964 (chart 7).



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The change within 1968, however, was very modest until late in the year. Nondefense purchases by all levels of government (up 11½ percent) continued their substantial and rather steady increases, reflecting the rising trend in State and local outlays and a considerable step-up in Federal nondefense purchases. Defense purchases recorded a 9 percent gain but showed little change after midyear. The 8½ percent rise in consumer expenditures dominated the dollar advance in final sales with widespread increases that were especially heavy for durable goods, particularly automobiles. Consumer spending started off the year with very large gains but subsequently exhibited a seesaw pattern of change attributable to fluctuations in the purchases of goods.

Investment in nonresidential structures and durable equipment remained high, with a moderate increase (7½ percent) that was larger than the 1967 rise but considerably smaller than the increases during the investment boom of 1964–66. A substantial pickup, however, became evident in the closing months of the year.

Sales to foreigners rose much more rapidly in 1968 than in 1967; but the rise in imports showed an even greater acceleration. Consequently, net exports declined to their lowest level since 1959.

GNP by type of product

The strong advance in demand last year led to large increases in all major types of production. The increases were dominated by the recovery in durable goods, which, in current dollars, rose

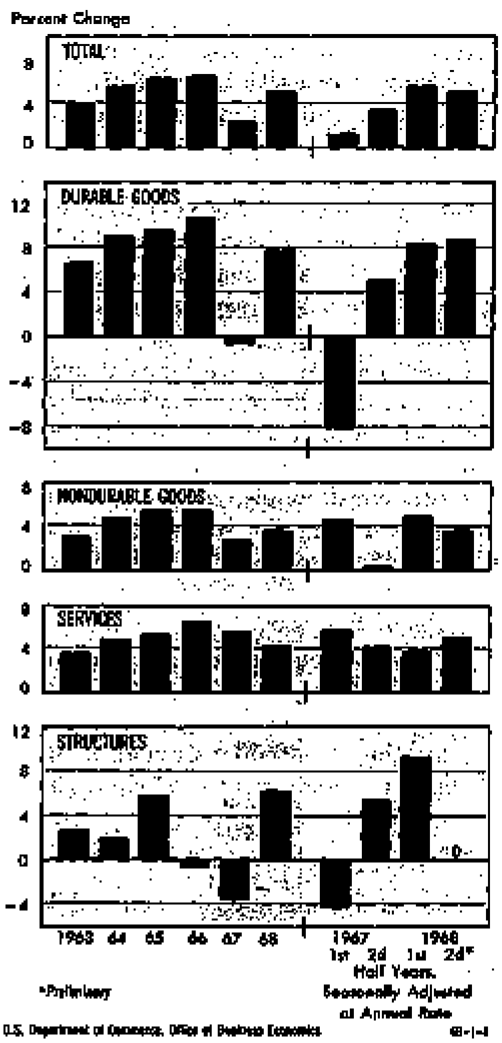
11 percent in 1968 after a gain of only 2 percent the year before. The rise in the value of durable goods production reflected chiefly last year's strong demand for automobiles and the moderate increases in business equipment outlays and in government purchases of hard goods.

Following a 1 percent gain in 1967, the value of structures rose almost 12 percent, reflecting chiefly last year's recovery in homebuilding. Service output rose 9 percent, about the same relative advance as in 1967, as government payrolls were increased and consumers added to their expenditures for services. Finally, the increased purchases by both consumers and government were responsible for the 7 percent rise in the value of production of nondurable goods; the year-earlier gain was 5 percent. Adjustments for the pronounced price increases of 1968 reduce the current dollar gains but do not greatly alter the pattern of change (chart 8).

CHART 8

Percent Changes in Real GNP By Type of Product

Last year's rise in production featured a recovery in durable goods production and construction



Personal Income, Consumption, and Saving

THE 1968 rise in personal income was the largest on record in absolute terms, and the largest since 1951 in percentage terms. The $57 billion or 9 percent increase over 1967 surpassed by a wide margin the sizable additions of the preceding 3 years and brought the total for the full year to $686 billion (chart 9.). The very large expansion in payrolls contributed the most to the 1968 income advance, but transfer payments and nonwage incomes also made notable gains.

Social Security benefit payments were boosted $2⅔ billion (annual rate) in March. For all of 1968, transfer payments expanded $7 billion, nearly as much as the unusually large increase in 1967, the first full year that Medicare payments were in effect. Partly in reflection of higher interest rates in 1968, personal interest income rose $5.3 billion, the largest gain on record. Dividend payments increased somewhat more than in 1967, while rental income of persons and incomes of nonfarm proprietors advanced at about the 1967 rates. Farm income recovered moderately, following the 1967 decline.

Personal taxes increased by an exceptional $14½ billion from 1967 to 1968. The Federal portion of this rise was $12 billion, of which $3½ billion represented larger withholdings and quarterly declarations as a result of the imposition of the Federal surtax in July. The remainder reflected the increased tax payments on higher incomes. Total personal tax payments of $97 billion constituted 14 percent of personal income in 1968 as compared with a ratio of 13 percent in 1967.

Because of the sizable increase in taxes, the rise in disposable personal income over 1967 was dampened to $42½ billion, or 7¾ percent. Since consumer prices advanced 3.6 percent in 1968 (GNP basis), the rise in real after-tax income came to 4 percent.

Sharp rise in consumer spending

The expansion in consumer spending in 1968 was the largest in percentage

Disposable Personal Income and Consumer Expenditures

Year	Current prices: Disposable personal income (Bil. $)	Current prices: Personal consumption expenditures (Bil. $)	Current prices, Per capita: Disposable personal income (Dollars)	Current prices, Per capita: Personal consumption expenditures (Dollars)	Constant prices: Disposable personal income (Bil. 1958 $)	Constant prices: Personal consumption expenditures (Bil. 1958 $)	Constant prices, Per capita: Disposable personal income (1958 dollars)	Constant prices, Per capita: Personal consumption expenditures (1958 dollars)
1963	404.6	375.0	2,138	1,980	381.3	353.2	2,018	1,865
1964	438.1	401.2	2,280	2,088	407.9	373.7	2,128	1,945
1965	473.2	432.8	2,432	2,224	435.0	397.7	2,235	2,044
1966	511.6	465.5	2,599	2,364	459.2	417.8	2,332	2,122
1967	546.3	492.2	2,744	2,473	478.0	430.5	2,401	2,163
1968	589.0	533.7	2,935	2,659	497.4	454.7	2,473	2,240
Percent change:								
1963–64	8.3	7.0	6.7	5.5	7.0	5.8	5.5	4.3
1964–65	8.0	7.9	6.7	6.6	6.5	6.4	5.3	5.1
1965–66	8.1	7.6	6.8	6.3	5.6	5.1	4.8	3.8
1966–67	6.8	5.7	5.6	4.6	4.1	3.0	3.0	1.9
1967–68	7.8	8.4	6.7	7.3	4.1	4.7	3.0	3.6

Source: U.S. Department of Commerce, OBE.

terms since 1947. The $42½ billion or 8½ percent gain over 1967 brought total expenditures to $534 billion. As in other years of large increases in consumer spending—such as 1955, 1965, and 1966—purchases of automobiles were exceptionally high.

Sharply higher prices accounted for a large proportion of the 1968 current dollar increase in spending; after allowance for the price advance, the physical volume of goods and services purchased by consumers in 1968 increased 4.7 percent, as compared with 3 percent in 1967. The 1968 rise in physical volume was less than in each of the 3 years preceding 1967, as the accompanying table shows.

Consumer expenditures for durable goods registered a striking advance of 13½ percent last year, with higher prices accounting for about one-fifth of the dollar increase. Expenditures for nondurable goods and services increased nearly 7 and 8½ percent respectively; half of these gains were due to price increases.

Major expenditure groups

Among the major expenditure groups, the largest rise in 1968—20 percent—occurred in autos and parts, a group that had shown almost no change for 2 years following exceptionally heavy purchases in 1965. New car sales (including purchases by business) increased 1.2 million units in 1968 to a record total of 9.6 million.

Aside from the exceptional rise for autos, relative increases by major categories were fairly uniform last year, in contrast to the 1967 experience. This is clearly indicated in chart 10. The furniture and clothing groups each gained 9 percent, while housing and household operation registered somewhat smaller increases. Expenditures for food showed the smallest gain over 1967—6½ percent.

Consumers devoted 6.8 percent of their 1968 expenditure dollar to autos and parts—a larger fraction than in either of the 2 preceding years, but still less than the proportions spent in the boom auto years of 1955 and 1965. Furniture and other durable goods outlays, on the other hand, accounted for the same proportion of total spending in each of the past 3 years—about 8½ percent.

Expenditures for nondurable goods continued to decline relative to overall spending in 1968, and the ratio fell to a record low of 43 percent. In recent years, this downtrend has been due to food expenditures, which have consistently risen relatively less than total spending. For example, in 1968, food expenditures accounted for 22 percent of consumer spending as compared with 26 percent in 1958 and 31 percent in 1948. The share of the spending dollar absorbed by clothing has been stable at 8.6 percent for the past 3 years. This was preceded by a 5-year period when the proportion was 8.3 percent; the recent rise in the share reflects the emergence of sharp increases in clothing prices. Fluctuations in the ratios for the other major nondurable goods groups have been rather small in recent years.

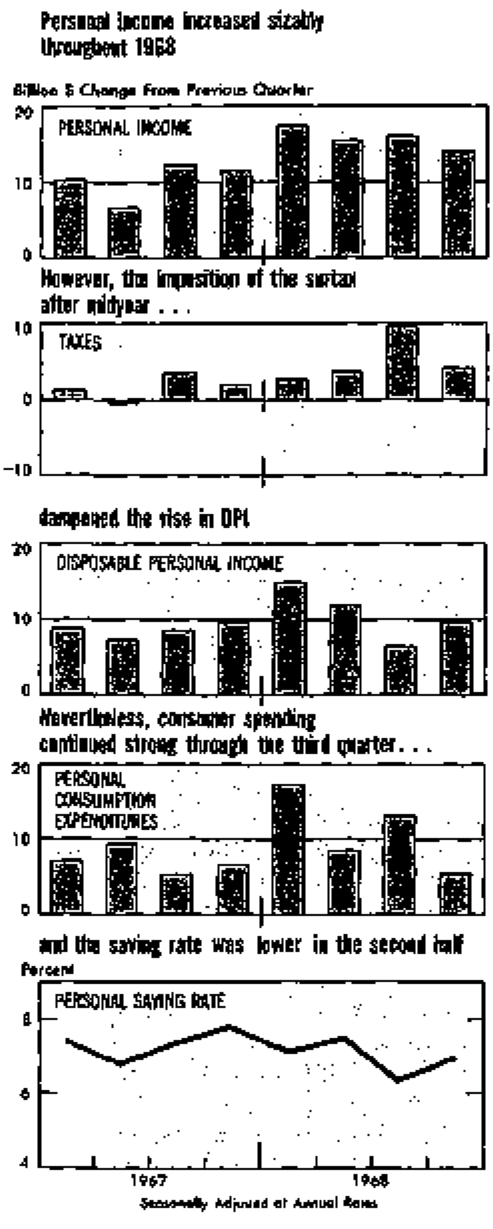
The proportion of total spending devoted to services in 1968 remained at 41 percent, the same as in 1967, but higher than in preceding years. Further increases in the fraction spent for medical care services were offset by small reductions for some of the other groups.

Quarterly spending pattern

The quarterly increases in consumer expenditures during 1968 showed marked

CHART 9

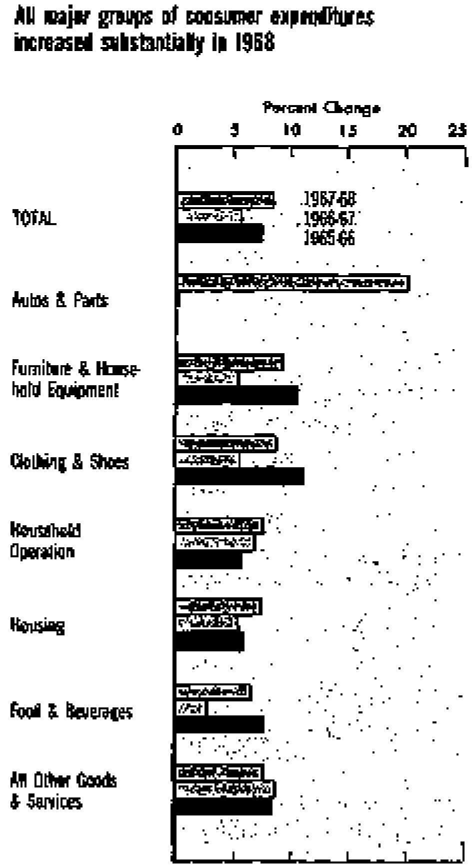
Changes in Personal Income and in Its Disposition



U.S. Department of Commerce, Office of Business Economics 69-1-9

CHART 10

Personal Consumption Expenditures



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variations, not only in absolute terms but also in relation to disposable personal income. The first quarter rise of $17 billion (seasonally adjusted annual rate) was the largest quarterly increase on record. In part, it reflected a makeup in auto sales, which had been limited by the strikes in late 1967. But the rise was broadly based. Expenditures for furniture and household equipment spurted following a sluggish performance during 1967, while spending for nondurable goods expanded with strong gains for all major groups, particularly food and clothing.

It was not likely that the extraordinary first quarter increase could be maintained. The second quarter increase of $8½ billion was only half as large as the first quarter rise, with the changes in expenditures relatively small for most categories. A smaller expansion in income and disturbances in the cities contributed to the second quarter slowdown.

The increase in consumer spending accelerated to $13 billion in the third quarter, notwithstanding a rise in personal taxes of almost $10 billion at an annual rate. About $5½ billion of the tax rise was due to increased withholdings under the surtax that became effective in July. Large increases were registered in outlays for autos and parts, for furniture and household equipment, and for the groups that had lagged in the second quarter.

In the fourth quarter, the increase in consumer spending fell to about $5 billion, even though disposable income advanced by $10 billion. The slower rise in expenditures for goods was general and included a leveling off in auto purchases and a decline in purchases of household durables. As noted earlier, the influenza epidemic in December probably hurt retail sales but by how much is not known; in any case, a slowdown in the spending advance was evident before December.

In contrast to the erratic quarterly movements for durable and nondurable goods expenditures in 1968, the dollar increases for services were much more regular, averaging about $4½ billion per quarter.

Saving rate lower

For 1968 as a whole, the ratio of personal saving to disposable personal income was reduced to 6.9 percent from 7.4 percent in 1967. After remaining at 6.0 percent in 1964 and 1965, the saving rate had increased to 6.4 percent in 1966 and to the unusually high rate of 7.4 percent in 1967. The 1968 reduction is apparently associated with larger expenditures for autos and parts; changes in these expenditures are usually reflected in changes in the saving rate. If these expenditures are added to the saving rate, there is little difference between 1967 and 1968.

The decline in personal saving was especially marked from the second quarter of 1968 to the third, dropping from 7.5 percent of disposable income to 6.3 percent. At the very time that tax withholdings were boosted, consumers increased their spending twice as fast as their after-tax incomes rose. It now appears that the fourth quarter rate of saving rose to just under 7 percent, but it was still below the ratio in the first half.

A number of factors doubtless contributed to the drop in the saving rate in the second half. In part, it is associated with larger expenditures for automobiles and parts, as may be seen below.

	1967	1968				
		Year	I	II	III	IV
Ratio to DPI:						
Personal saving	7.4	6.9	7.1	7.5	6.3	6.6
Consumer expenditures on autos and parts	5.6	6.2	6.0	6.1	6.4	6.6
Total	13.0	13.1	13.1	13.6	12.7	13.2

In addition, the impact of the tax increase may have been delayed; this is suggested by the fact that the rise in consumption slowed in the fourth quarter and the saving rate increased. Another possibility is that an inflationary psychology motivated consumers to spend relatively more of their incomes; last summer and fall, price increases were in prospect for many items, such as automobiles, apparel, and furniture.

Business Fixed Investment

BUSINESS investment in producers' durable equipment and nonresidential construction in 1968 showed only a moderate gain for the second successive year. Expenditures totaled $90 billion for the year as a whole, up $6 billion, or about 7 percent, from 1967 (chart 11). The increase was larger than the 3 percent advance in 1967 but about half the large annual increases in the years 1964–66, when an investment boom was underway. A significant shift in the investment climate took place during 1968, and investment became a strong source of demand late in the year.

With construction costs rising substantially and equipment prices continuing to advance, the 1968 rise in business fixed investment in real terms came to 4 percent; in 1967, the real volume of these outlays had barely matched the 1966 total. The share of business fixed investment relative to total output edged down slightly but remained high relative to the average of the past decade (chart 11).

Expansion in nonmanufacturing

Industries covered in the OBE–SEC capital expenditures survey, which is somewhat less comprehensive than the national accounts measurement of investment, showed a rise of 4½ percent from 1967 to 1968 and less than 1 percent when price increases are taken into account. The increase centered mainly in nonmanufacturing industries, where investment in current dollars was up 8 percent, as compared with a 4 percent increase in 1967. Manufacturers held current dollar outlays close to 1967 totals; expenditures had declined 1 percent from 1966 to 1967 after the strong gains of 1964–66.

For the year as a whole, durable

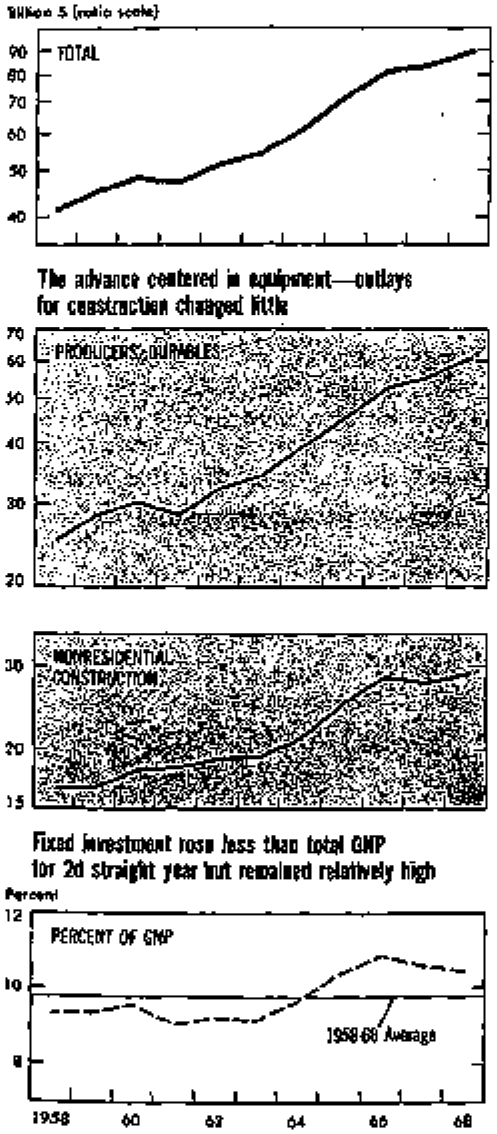
goods producers' outlays—at $13.6 billion—were slightly below 1967 expenditures. Within this goods group, most industries showed cutbacks, with the largest—about 7 percent—in transportation equipment. Only the electrical machinery and the "other durable goods" groups (including lumber, furniture, fabricated metals, and miscellaneous) expanded outlays in 1968. Soft goods manufacturing companies increased their expenditures for plant and equipment about 1½ percent—to $13.2 billion—owing to the enlarged expansion programs of petroleum, rubber, and "other nondurable goods" groups (including apparel, leather, printing and publishing, and tobacco). Paper, chemicals, and textiles reduced outlays; for the last two industries, it was the second year in a row of declining investment.

In the nonmanufacturing sector, nonrail transportation firms, paced by the airlines, and public utilities lifted their capital spending by one-seventh—marking the fifth successive year of substantial expansion. Except for railroads, the other nonmanufacturing groups—communications, commercial, and mining firms—reported modest increases in capital outlays. Railroads reduced their 1968 outlays only slightly, in contrast to very substantial cutbacks in 1967.

CHART 11

Nonresidential Fixed Investment

Rose moderately in 1968 after little increase in 1967



U.S. Department of Commerce, Office of Business Economics 69-1-11

Rise in second half

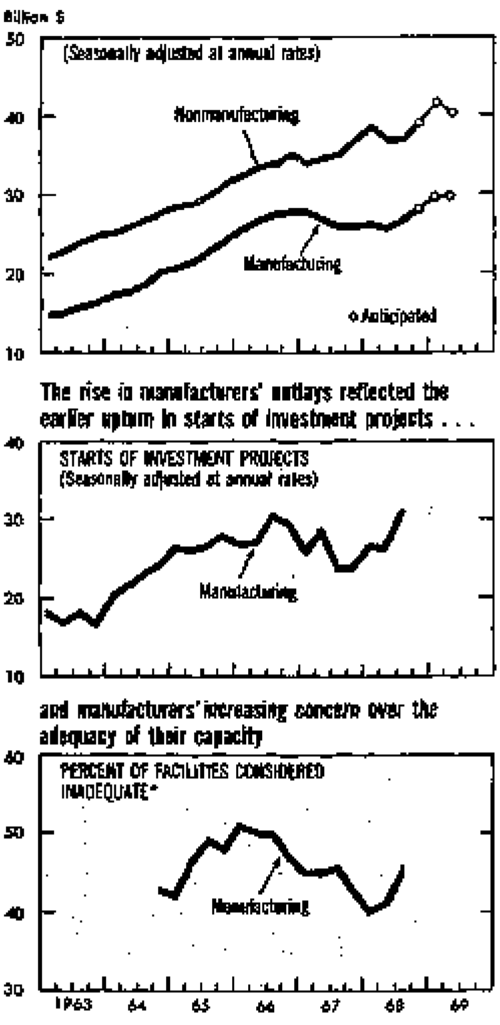
The highlight of investment in 1968 was the unexpectedly strong showing of investment programs late in the year. Early in 1968, businessmen had programed a 6 percent rise over actual 1967 expenditures, with a dip in the first half to be followed by a modest upturn. They carried out this projected pattern in broad outline for the first three quarters of the year, spending somewhat less than anticipated in each quarter. In the fall, however, they showed major upward revisions in spending programs. According to the OBE–SEC survey published in December 1968, businessmen in both manufacturing and nonmanufacturing industries projected an extremely large $4 billion rise (annual rate) from the third to the fourth quarter and a rise of more than $3 billion from the fourth quarter to the first half of 1969.

The turnabout in manufacturers' spending programs after mid-1968 reflected an upturn in the start of new investment projects that began around the end of 1967 (chart 12). Changes in these starts tend to be reflected in expenditures some two to three quarters later. Starts accelerated sharply in both the durable and nondurable goods groups in the third quarter of 1968 (the latest period for which data are available) to a point 30 percent above their fourth quarter 1967 rate.

It is still a little early for a definitive explanation of the strong investment recovery. It is probably significant that sales increased substantially during 1968, equaling or exceeding businessmen's expectations; sales had tended to fall below expectations throughout 1967. Moreover, as the year progressed, an increasing number of manufacturers became concerned about the adequacy of their capacity (bottom panel of chart 12), even though actual capacity utilization was well below preferred rates. At the end of September, manufacturers holding 45 percent of total gross assets in manufacturing reported

CHART 12

Plant and equipment expenditures showed yearend strength in both manufacturing and nonmanufacturing



*In view of current and prospective sales over the next 12 months.

Data: OBE-SEC

U.S. Department of Commerce, Office of Business Economics 69-1-12

that they needed more plant and equipment facilities to meet production requirements in the next 12 months—as compared with 41 percent in June and 40 percent in March. The summer rise, which extended over a wide range of industries, interrupted the steady decline in this percentage that began in the second quarter of 1966.

Housing

RESIDENTIAL construction activity, which turned up in early 1967, advanced further during 1968 as housing starts rose to their highest level in 4 years. For the full year, outlays totaled $30.0 billion, a $5½ billion increase over 1967. Unlike the large quarter-by-quarter rise during 1967, the advance in activity during 1968 was irregular: Expenditures rose approximately $½ billion in each of the first two quarters, leveled off during the summer months, and then increased $2¼ billion in the fourth quarter. When the rise in construction costs is taken into account the 22 percent increase in current dollars for the full year is cut to 16 percent.

Starts up in 1968

Underlying last year's rise in expenditures was an 18 percent increase in private nonfarm housing starts, which totaled about 1½ million units in 1968 (chart 13). The upward movement in starts that began late in 1966 continued through the first quarter of 1968, but the tightening of credit during the winter and early spring caused a temporary setback in the recovery. Starts declined 3½ percent from the first to the second quarter to an annual rate of about 1.4 million units. Somewhat easier credit conditions during the summer and early fall permitted a resumption of the forward movement, and by the fourth quarter, the annual rate had advanced to 1.6 million units.

Single-family starts reached nearly 900,000 units, up 10 percent from 1967; the multifamily total of 600,000 starts represented a one-third gain from the preceding year. The rise in multifamily units brought these starts slightly above the 1963 peak but single family starts still trailed the rates reached earlier in the 1960's. The relatively larger rise in multifamily construction is probably related to the pattern of household formation in recent years, which has been concentrated in the younger age groups, who typically rent rather than buy. In addition, the more stringent downpayments and interest rate charges required on single-family home purchases have also favored apartment house accommodations.

Despite last year's increase in starts, for the third year in a row the volume of starts was below the combined total required for new household formation plus estimated replacements. This shortfall has caused a substantial backlog to build up; consequently, vacancy rates have fallen to the lowest point in 10 years (chart 14), and pressures on home prices and rents have intensified. The tight market for conventional housing has also stimulated the production of mobile homes, which advanced 20 percent in 1968 to a rate double that 5 years earlier. (These are not included in housing starts figures).

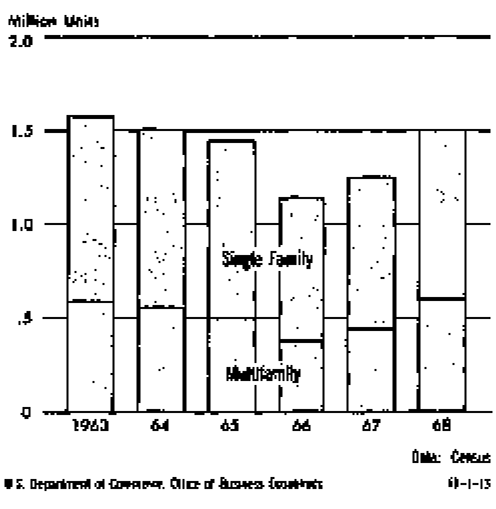
Mortgage lending higher

Enlarged credit flows to housing markets were a key factor in last year's strong rise in residential construction activity. On the basis of data that are still incomplete for the fourth quarter, nonfarm residential mortgage lending increased about $18½ billion in 1968. This expansion compares with increases of $16 billion in 1967 and $13.7 billion in 1966, and about matched the average advance from 1961 to 1965.

Although mortgage lending held at relatively high levels in 1968, lending appears to have varied little during the first three quarters of the year on a seasonally adjusted basis. It showed some pickup in the final quarter to a rate approximately matching that in the second half of 1967. Last year's restrictive monetary policy and high and generally rising interest rates exerted a dampening influence on mortgage lending and housing activity. First, the high levels reached by market rates of interest were mainly responsible

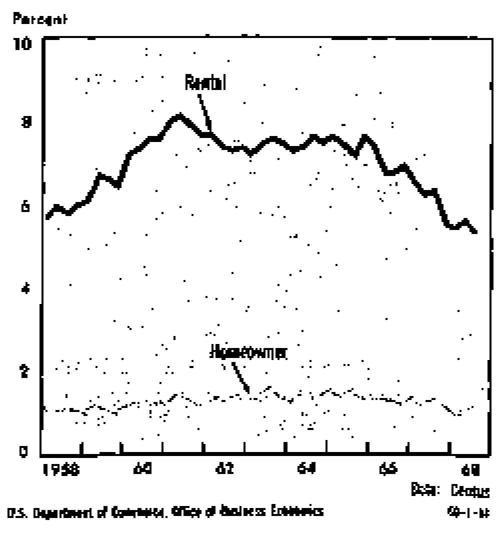
Private Nonfarm Housing Starts

Starts rose 18 percent in 1968 as multifamily units exceeded 1963 peak
Single family units, while higher, continued to trail 1963-65 rate



Vacancy Rates

Last year rental and homeowner vacancy rates were the lowest in a decade



for a pronounced slowdown in the flow of savings to deposit-type institutions. With market rates of interest above the ceilings that commercial banks, savings and loan associations, and mutual savings banks were permitted to pay on savings accounts, these institutions encountered difficulties in attracting and holding saving-type deposits. This development limited their ability to make mortgage loans. In addition, last year's rise in market rates of interest narrowed the spread between yields on mortgages and rates of return on competitive open market investments. Under these circumstances, some mortgage lenders tended to curb their residential mortgage lending activities.

Mortgage funds were available last year only at very high cost. The yield of FHA new home mortgages averaged 7.12 percent, as compared with 6.53 percent in 1967 and 6.40 percent in 1966. Although the high rates on mortgage loans were indicative of serious pressures in mortgage markets last year, the situation at no time became as critical as in 1966. There were a number of important differences between the 2 years. First, the mortgage lending institutions, as well as the Federal Home Loan Bank System, were generally in a more liquid position in 1968 than in 1966. Second, in spite of the sharp rise in market rates of interest, the slowdown in deposit flows to thrift institutions was not as severe as it was 2 years ago. This development is explained by several factors: Regulation Q reduced the competition for deposits between these institutions and the commercial banks; some of the highly interest-sensitive deposits that left the thrift institutions in 1966 apparently never returned; and the savings and loan associations have acquired greater deposit stability since 1966 through the issuance of saving certificates carrying higher rates than regular share accounts and maturities extending 6 months and more. Finally, the profit margins on mortgage loans were substantially greater in 1968 than 1966, since the rates paid by lending institutions for deposits rose less last year than in 1966 while those earned on mortgage loans rose more.

Inventory Investment

IN marked contrast to the 2 preceding years, when changes in inventory investment constituted a dynamic element in the economy, business accumulation of inventories in 1968 was not a significant source of change in GNP. For the year as a whole, businessmen added about $7½ billion to their inventories, only about $1½ billion more than the 1967 accumulation, which was far below the record $14.7 billion rise of 1966.

Virtually all of the increase in business stocks in 1968 was reported by nonfarm concerns, up $7.2 billion in 1968 as compared with $5.6 billion in 1967. Here, durable goods companies accounted for all of the rise in accumulation since nondurable investment was the same in both years. Farm stocks advanced a little less in 1968 than in 1967.

In 1968 as in 1967, manufacturers accounted for the major part of the overall inventory accumulation, but the rise of almost $4 billion in their stocks last year was somewhat less than their 1967 addition. Stocks of trade firms rose $2.8 billion last year, considerably more than the $0.5 billion rise during 1967.

The pattern of inventory investment within the year was very irregular, in part reflecting varying rates of expansion in sales, especially at retail. In the opening quarter of 1968, a largely unexpected upsurge in sales caused inventory investment to fall sharply, but this movement was reversed in the spring as the expansion in sales abated. The rate of inventory accumulation edged down in the summer but appears to have picked up again in the closing quarter of the year as trade sales showed no further rise.

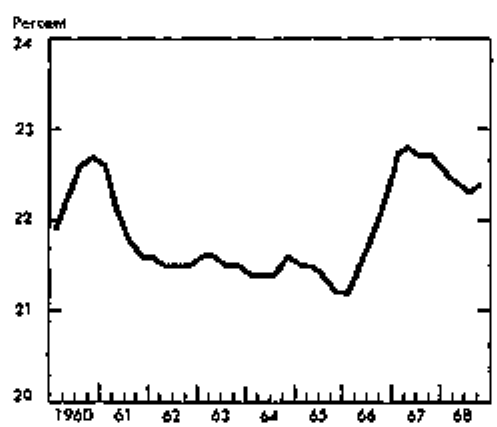
Inventory investment during the year also reflected special influences affecting steel and automobiles. The stockpiling of steel against the possibility of a steel strike at the end of July bolstered inventory investment in the first half of the year; with a strike averted, steel consumers liquidated stocks during the second half. Auto dealers added heavily to their stocks in the first 6 months of 1968 to make up for the deficiencies caused by the auto strike in late 1967, but made only slight further additions in the final 6 months.

The ratio of nonfarm stocks to GNP in 1958 dollars (chart 15) continued to recede during the year from the peaks of early 1967, but remained above the average of the preceding 5 years.

Manufacturers' additions

With contributions from all major industries, manufacturers of durable goods added about $2 billion to their stocks in 1968, down from a $3 billion increase of 1967. The defense product industries, whose additions to inventory made up one-half of the total in 1967, contributed only one-third of the smaller 1968 increase. The rate of inventory investment by machinery and equipment firms also fell in 1968, with the total stock increase for this group only one-quarter of the 1967 increase.

Ratio of Nonfarm Stocks to GNP



Note.—Based on seasonally adjusted constant dollar data. Stocks, average for quarter; GNP at annual rates.

U.S. Department of Commerce, Office of Business Economics 69-1-15

The major increase in durable goods manufacturers' inventories in 1968 occurred in the work-in-process stage of fabrication, although holdings in both the materials and supplies and finished goods categories also rose during the year.

Stocks held by nondurable goods manufacturers rose $1.3 billion in 1968, about $½ billion more than the year before. The 1968 increase was widely distributed among the component industries. About 60 percent of the advance consisted of finished goods, with the remainder fairly evenly divided between materials and work-in-process.

Trade inventories rise

Durable goods retailers, whose stocks declined in 1967, contributed most to the expansion in retail inventories during 1968. Virtually all of the $1½ billion increase was attributable to larger holdings of retail auto dealers, in sharp contrast to the decline in these stocks during 1967. Other major durable goods retailers lifted their stocks slightly during 1968 but with gains somewhat less than those of the year before.

Stocks held by nondurable goods dealers rose at a steady pace throughout the year, accumulating $0.7 billion for the year as a whole —$½ billion more than in 1967. Most of the increase was reported by general merchandise stores.

Wholesalers added about $0.7 billion to their stocks in 1968, less than the accumulation in 1967. Durable goods wholesalers accounted for the bulk of this increase, largely in the metals and metal products groups affected by the threatened steel strike in the middle of the year.

Stocks of nondurable goods wholesalers showed little change this year as compared with about a $1 billion increase in 1967. A slow start in the first quarter and widespread increases during the second were followed by a drop in the third, due largely to smaller holdings of farm products and raw materials. During the fourth quarter, the trend turned upward again.

Stock-sales ratio

The foregoing analysis of inventory changes was based largely on stock holdings after inventory valuation adjustment (GNP basis). In terms of book values, manufacturing and trade inventories rose about $10 billion during 1968, considerably more than the $6.6 billion rise in the preceding year. Over $3 billion of the 1968 book value rise was attributable to higher inventory replacement cost. Manufacturers' stocks rose nearly $6.0 billion during the year, retailers' stocks over $3.0 billion, and wholesalers' inventories about $1.0 billion.

For all manufacturing and trade firms, the ratio of (book value) stocks to sales was lower at the end of November 1968 than at the end of 1966 and 1967. However, the ratio was higher than those for the preceding 5 years. The same broad pattern is evident in the separate ratios for manufacturing, wholesale trade, and retail trade. It may well be that with expectations of rising sales and prices, businessmen do not consider their inventory position to be burdensome.

Government Expenditures and Receipts

GOVERNMENTS at all levels made an important contribution to the rise in final demand last year. Their purchases of goods and services rose nearly $19 billion—divided about equally between Federal and non-Federal—to a total of $197 billion. Although the increase was somewhat smaller than in the previous year, its share of the rise in total production was considerably less—25 percent as compared with 50 percent in 1967. Nondefense outlays (including those of State and local governments) rose about $12 billion in 1968 as compared with about $10½ billion in 1967. Returning to the pattern of change in the early 1960's, these purchases advanced more than those for defense. The earlier trend was broken around mid-1965 when the Federal Government stepped up its outlays for the war in Vietnam.

Other government expenditures, such as transfer payments and interest, also continued to increase in 1968. The $7½ billion advance over the previous year brought the rise in total expenditures of all governments to about $26 billion (NIA basis).

Large as these were, they were exceeded by an increase in receipts of $33½ billion. The 1967–68 advance in receipts was a record gain, the result of increased yields from existing taxes in a rapidly expanding economy and new taxes or higher tax rates at all levels of government, notably the Federal surcharge on individuals and corporations. The Federal tax increase was enacted at midyear in an effort to minimize the Federal budget deficit

Manufacturing and Trade: Ratios of Stocks to Sales

End of year	Total manufacturing and trade	Manufacturing			Retail			Merchant wholesalers		
		Total	Durable goods industries	Nondurable goods industries	Total	Durable goods stores	Nondurable goods stores	Total	Durable goods establishments	Nondurable goods establishments
1961	1.50	1.68	1.93	1.42	1.30	1.86	1.16	1.16	1.57	0.88
1962	1.53	1.77	2.05	1.48	1.38	1.82	1.16	1.15	1.57	.85
1963	1.49	1.66	1.91	1.38	1.40	1.84	1.20	1.18	1.64	.88
1964	1.45	1.62	1.83	1.37	1.37	1.74	1.16	1.13	1.40	.85
1965	1.45	1.60	1.80	1.34	1.40	1.84	1.18	1.13	1.47	.86
1966	1.56	1.72	2.00	1.37	1.51	2.11	1.22	1.22	1.41	.91
1967	1.56	1.78	2.01	1.37	1.40	2.07	1.22	1.23	1.57	.94
1968 [1]	1.53	1.67	1.96	1.31	1.47	2.08	1.19	1.10	1.50	.92

[1] End of November.

and to dampen inflationary pressures in the economy.

Smaller deficits in 1968

With receipts advancing more than expenditures, both Federal and State and local governments moved toward smaller deficits in 1968. The change was most pronounced in the Federal sector, where the deficit declined to $5½ billion from the record $12½ billion level shown in 1967. This change occurred primarily in the second half of the year, when the deficit averaged about $1½ billion at an annual rate as compared with more than $9 billion in the first half. The sharp second-half shift reflected the higher taxes and lower expenditures called for by the Revenue and Expenditure Control Act of 1968 passed by Congress in June.

This legislation provided for (1) a 10 percent surcharge on corporate and individual income taxes, effective January 1, and April 1, 1968, respectively, with individual withholding beginning July 15; (2) an extension of the 1967 excise tax rates on automobiles and telephone services to January 1970; and (3) a ceiling on expenditures in fiscal 1969 that allowed for some exemptions, such as expenditures for Vietnam, interest, and social security. The new legislation also placed a limitation on the number of civilian employees in the Federal Government.

Federal Government

The Federal Government purchased $100 billion of goods and services in 1968. The advance of nearly $9½ billion, although substantial, was the smallest since the Vietnam buildup began in 1965.

Defense spending increased only $6½ billion last year as compared with nearly $12 billion in 1967 primarily because of slower growth in the delivery of goods. These deliveries accounted for a much smaller proportion of the gain in defense purchases than in 1967, as the following table shows:

	1966	1967	1968
	Change from previous year, ($ billions)		
National defense purchases	10.4	11.8	6.6
Employee compensation	3.6	2.8	3.3
All other goods and services	6.9	9.0	3.2

Moreover, most of the slowdown in the deliveries of goods was centered in the procurement of major defense items.

	1966	1967	1968
	Change first 9 months, ($ billions)		
Total procurement	3.2	4.1	.7
Aircraft	1.2	1.4	------
Ordnance, vehicles, and related equipment	.8	2.6	-.7
Electronics and communications equipment	.2	.2	-.3
All other procurement	1.1	------	-.2

Of the other major defense expenditure categories, operation and maintenance costs were up considerably less in the first 9 months of 1968 as compared with the same period of 1967, while expenditures for research and development declined.

In contrast to last year's smaller gains in the purchases of goods, compensation of military and civilian personnel advanced somewhat more than in 1967. The strength of the Armed Forces increased by about 150,000 men through the first half of the year, peaking in June at over 3.5 million. This increase partly reflected the reserve callup following the Tet offensive and the Pueblo incident. However, from June to November (the latest month available) there was a decline of over 100,000 men. Civilian employment in the Department of Defense, about 1.1 million employees, showed little change after increasing substantially in 1967.

Two civilian and military pay raises also added to the increase in 1968 compensation. The first, effective in October 1967, added about $¾ billion to the 1968 increase in Defense Department compensation; the second raise, effective July 1968, added another $½ billion.

Surge in nondefense purchases

Federal nondefense purchases registered a record $3 billion gain that brought the total to more than $21 billion for the year. This rise was due to two major factors. The first was a $2 billion increase in purchases by the Commodity Credit Corporation. The large advance in agricultural purchases was a result of expanded output, particularly in wheat and soybeans, whose prices fell considerably. The second factor responsible for the rise was a large increase in payrolls reflecting the two pay raises. The following table shows the composition of the increases in nondefense purchases in recent years.

	1966	1967	1968
	Change from previous year ($ billions)		
Total nondefense purchases	.8	1.4	3.3
Employee compensation	.6	.4	.7
Commodity Credit Corporation	-1.6	1.9	2.1
NASA	.4	-1.1	-.3

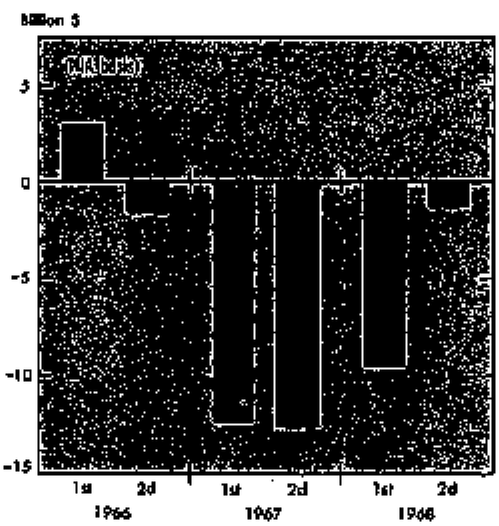
OASDI benefits advance

Other categories of Federal expenditures—transfers, grants, interest, and subsidies—amounted to more than $62 billion in 1968. These advanced more than $9 billion last year, or some $1 billion more than in 1966 and 1967. As in 1967, transfer payments to persons were the strongest element in the advance, accounting for over $5½

CHART 16

Federal Deficit

Tax increase and expenditure slowdown reduced deficit in second half



Half Years, Seasonally Adjusted at Annual Rate

U.S. Department of Commerce, Office of Business Economics

billion of the total gain. However, in contrast to 1967, when medicare transfer payments accounted for half of the increase in total transfers, over 60 percent of the 1968 rise resulted from OASDI benefits.

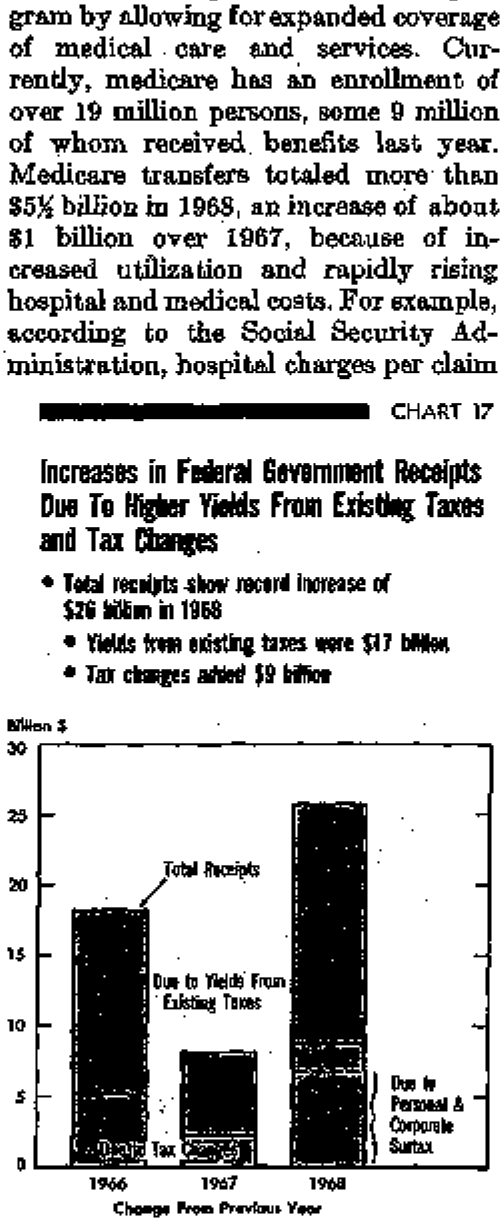
The large gain in OASDI payments—about $3¼ billion— was mainly the result of the 1967 amendments to the Social Security Act. The chief provisions under these amendments called for a 13 percent across-the-board increase in benefits—the sixth since the program started and the largest since 1950—and a rise from $44 to $55 in the minimum monthly payment.

The Social Security Amendments of 1967 also enlarged the medicare program by allowing for expanded coverage of medical care and services. Currently, medicare has an enrollment of over 19 million persons, some 9 million of whom received benefits last year. Medicare transfers totaled more than $5½ billion in 1968, an increase of about $1 billion over 1967, because of increased utilization and rapidly rising hospital and medical costs. For example, according to the Social Security Administration, hospital charges per claim (not all of which are reimbursable) increased from $656 in July 1967 to $737 in July 1968. Medical charges per bill (again, not all reimbursable) increased from $59 in August 1967 to $64 in August 1968.

CHART 17

Increases in Federal Government Receipts Due To Higher Yields From Existing Taxes and Tax Changes

- Total receipts show record increase of $26 billion in 1968
  - Yields from existing taxes were $17 billion
  - Tax changes added $9 billion



U.S. Department of Commerce, Office of Business Economics 69-1-17

Larger benefits for veterans also added to the rise in personal transfers. The largest increase occurred in education benefits for veterans returning from Vietnam. Veterans' pensions and readjustment benefits also rose owing to cost-of-living increases and other adjustments provided for by recent congressional action.

Medicaid boosts grants

Grants-in-aid to State and local governments—nearly $18½ billion last year—advanced more than $2½ billion, almost double the rise of 1967. Public assistance grants, particularly for aid to dependent children (AFDC) and medicaid, accounted for the bulk of this increase, rising by over $¾ billion. The number of recipients receiving AFDC increased from 5.1 million in August 1967 to 5.7 million in August 1968; the average monthly payment in the same period increased from about $38 to $42. Highway grants rose almost $½ billion in 1968 after declining nearly $¼ billion in 1967, when they were held back for some time as a means of limiting budget expenditures.

Net interest paid amounted to nearly $12 billion in 1968, advancing by over $1½ billion because of rising interest rates and a larger public debt. The rise in market interest rates to the highest levels in 40 years accounted for about two-thirds of the higher costs of financing the Federal debt. The average interest rate (as of November 30) was about 4.6 percent on an interest-bearing debt of $354 billion as compared with 4.3 percent on a debt of $342 billion in 1967.

Subsidies (less the current surplus of government enterprises) recorded a moderate decline of about $¼ billion for the second straight year. This decline was the result of offsetting factors: (1) Government payments to farmers showed a gain of about $½ billion owing to increased participation in the feed grain program, while (2) government enterprise deficits, particularly for the CCC and the Post Office, were down nearly $¾ billion from 1967. The decline in the Post Office deficit reflected postal rate increases, partly offset by pay raises for postal workers.

Record rise in receipts

Federal receipts advanced a record $26 billion in 1968 to nearly $177 billion. About $17 billion of this exceptional rise was due to increased yields of existing taxes on higher personal income, profits, and employment. The additional $9 billion was the result of the 10 percent surcharge on personal and corporate taxes—nearly $7 billion of the total—and of an increase in the maximum earnings subject to social security taxes.

Among the various types of receipts, the largest increase—about $12 billion—was in personal tax and nontax receipts. Over one quarter of this advance was the result of the surcharge that affected payrolls beginning July 15. However, even before the surcharge went into effect, personal taxes were increasing rapidly because of the substantial gains in personal income and a rising marginal withholding rate.

Corporate profits tax accruals advanced $7¼ billion last year. The increase was divided about equally between the effects of the surcharge and the large rise in corporate profits.

Indirect business taxes also moved ahead strongly—about $1¾ billion—in contrast to relatively smaller gains throughout the 1960's. Tax liabilities on autos and trucks led the advance, reflecting the recovery of vehicle production following the 1967 decline.

Contributions for social insurance programs advanced $4¾ billion; this was some $1 billion more than the increase in 1967, but was well below the record $8 billion gain recorded in 1966. Most of the 1968 rise—over $4 billion—came in OASDHI contributions. The increase in the wage base for social security tax purposes—from $6,600 to $7,800 effective in January—accounted for $2 billion of this advance. Also, in April, the voluntary supplementary medical insurance (SMI) monthly payment was increased from $3 to $4, adding some $200 million to contributions. This category of receipts will also advance sharply in 1969 as the combined social security tax rate is scheduled to increase from 8.8 to 9.6 percent this month, adding about $3 billion (annual rate) in the first quarter.

State and Local Governments

State and local governments continued to be an important factor in final demand, generating $97 billion in purchases of goods and services in 1968, $9 billion more than in 1967.

As usual, the rise in purchases centered in employee compensation, which advanced almost $6¼ billion. Average pay and employment levels continued their steady growth. State and local government employment increased nearly 500,000 persons last year, with about two employees being added in education for each employee added in all other functions combined.

New construction outlays advanced over $2 billion, slightly exceeding the 1967 increase. Education construction—a major component of the total—showed signs of leveling off, while expenditures for mass transit systems, highways, and hospitals moved up sharply.

The past few years have witnessed large increases in purchases other than those for compensation and construction, largely because of Federal programs. In particular, Federal grants for medicaid have expanded State and local purchases in the areas of health and welfare; by 1968, most State governments had enacted legislation to take advantage of the Federal program. As a result, expenditures on these programs last year increased about $1¼ billion to over $4 billion. This was twice the amount spent 2 years ago and compares with outlays of only $½ billion in 1960.

Other types of expenditures, such as transfer payments and net interest costs, advanced about $1 billion in 1968, somewhat more than the preceding year. Almost all of this rise occurred in transfer payments, which totaled over $9½ billion. The advance was attributable to both higher benefit payments and a substantial increase in the number of public welfare recipients, which increased more than one-half million persons in the first 9 months of 1968.

Receipts up sharply

Receipts of State and local governments totaled about $102½ billion in 1968 for an increase of $10½ billion, after an advance of $7¾ billion in 1967.

Of the major types of receipts, the largest—indirect business taxes—accounted about one-half of the increase. Property taxes represented $2½ billion of this rise, while State sales taxes increased $1½ billion, or more than 50 percent above the previous year's gain. Two-thirds of the 1968 advance was due to higher tax rates; 17 States raised sales taxes in the last 2 years. In addition, indirect business taxes were augmented by increased tax rates on motor fuel and cigarettes in several States.

Personal tax and nontax receipts rose more than $2 billion, or 15 percent. Rising incomes as well as higher tax rates in New York, Massachusetts, Mississippi, and the District of Columbia and a new personal income tax in Nebraska contributed to this large increase.

Corporate income tax accruals advanced over $¾ billion. A large share of this rise was attributable to higher rates in six States and the District of Columbia and to the adoption of new corporate income taxes in Michigan and Nebraska.

A summary of tax changes and new tax enactments by State governments appears in the table below.

While State and local yields from taxes were rising by slightly over 10 percent, Federal government grants-in-aid increased over 17 percent, or $2¼ billion. Much of this advance is in the form of built-in increases and does not represent new programs or major changes in existing ones. For example, as the number of persons on welfare increases, public assistance grants (including medicaid) rise automatically as the Federal government must match State and local outlays for these programs.

Second consecutive deficit

Despite growing surpluses of employee pension funds, State and local governments recorded a deficit for the

Tax Changes of State Governments, 1968

	Personal income	Corp. income	Sales tax	Cig. tax	Liquor	Gasoline	Other [1]	Est. yield ($ millions)
Alaska							X	n.a.
Arizona				X	X			n.a.
District of Columbia	X	X	X					n.a.
Florida			X	X	X			350
Idaho						X		3
Kentucky			X				XN	95
Maryland		X						12
Massachusetts	X	X						70
Michigan		N				X		110
Mississippi	X	X	X					69
Nebraska	N	N						50
New Jersey	X [2]	X		X		X	XN	117
New Mexico				X				4
New York	X	X		X		X	N	153
Oklahoma				X				15
Pennsylvania			X					130
Rhode Island		X		X		X		21
South Carolina							N	n.a.
South Dakota							N	n.a.
Texas			X				X	179
Vermont						X	X	3
Virginia			X		X			72
West Virginia								2
								1,451
States with tax taking no action	33	20	38	48	47	44	42	

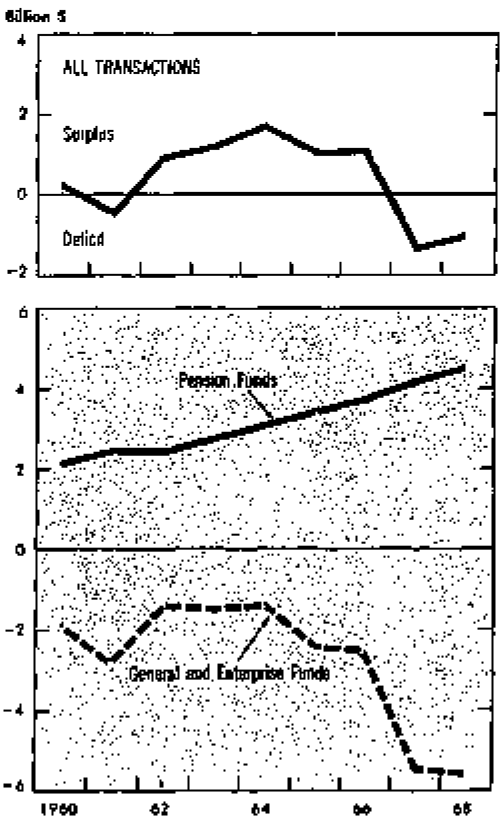
N New tax.
X Increase in existing levy.
N.a. Not available.
[1] Alaska, aviation fuel excise and oil and gas production tax; Kentucky, motor vehicle usage tax and realty transfer tax; New Jersey, motor vehicle licensing and registration and realty transfer tax; New York, realty transfer tax; South Carolina, gift tax; South Dakota, realty transfer tax; Texas, franchise tax; Vermont, rooms and meal tax.
[2] Commuter tax applicable only to New York residents working in New Jersey increased to conform with New York rates.

Sources: Tax Administration News; Tax Foundation, Inc.; Commerce Clearing House; Office of Business Economics.

second consecutive year. In 1968, these pension funds recorded a surplus of approximately $4½ billion, up from $4 billion a year earlier. In contrast, general funds of these governments continued to register a substantial deficit. Although general fund deficits have been common throughout the 1960's, they have grown markedly in the past 2 years. Increasingly, State and local administrators, faced with public concern about increasing tax rates, have turned to credit markets for new sources of funds. This has been evident in the past 2 years, when new bond issues by State and local governments increased very sharply despite rising interest rates. In 1967, bond issues increased almost 29 percent, and for the first 10 months of 1968, they were about 20 percent ahead of the comparable period a year earlier.

Fiscal Position of State and Local Goverments

Deficit shown for second straight year



U.S. Department of Commerce, Office of Business Economics 69-1-11

National Income

LAST year's advance in GNP was reflected in widespread income gains. Employee compensation posted a record annual increase of $45½ billion, or 9¾ percent. Corporate profits, which had declined in 1967, recovered strongly; on the basis of data that are still incomplete, before-tax profits rose 13 percent. Business and professional income as well as rental income rose about in line with recent experience, while the rise in net interest accelerated. Farm proprietors' income recovered sharply from the 9½ percent decline in 1967. Rising prices for farm products and a step-up in government payments were mainly responsible for last year's 5 percent increase in farm proprietors' income.

All told, the rise in national income came to $60 billion or 9 percent—a substantial advance over the 5 percent rise the year before. Although the dollar gain was the largest ever, the relative increase fell short of the 10 percent increase of 1966.

Employee compensation rises

Increased employment and much higher rates of pay brought about record dollar increases in private and public payrolls last year. The $45½ billion rise in employee compensation reflected a $30 billion gain in private wages and salaries, a $10 billion rise in government payrolls including military, and nearly a $5¼ billion advance in supplements (mainly employer contributions to Social Security and to private pension funds and health programs).

Increased man-hours accounted for only a minor part of last year's 9 percent gain in private wages and salaries (chart 19). With shortages in many labor markets already common as the year began, the heightened demands of 1968 elicited a sizable but not unusually large rise in employment—1.5 million or 2.8 percent. This was well below the average 4 percent gain in the years 1964–66, when large production advances occurred in a setting of higher unemployment.

The increase in employment last year accounted for all of the increases in man-hours as weekly hours of work, which have shown a secular downtrend for nonsupervisory employees, decreased slightly. Hours of work rose in most manufacturing industries, but this increase was more than offset by shorter hours in construction and trade.

Percent Change in National Income, by Industry

	1966–67	1967–68
All industries, total	5.2	9.2
Agriculture, forestry, and fisheries	−4.9	5.1
Mining and construction	3.1	7.6
Manufacturing	2.5	8.7
Nondurable goods	3.6	8.5
Durable goods	1.9	9.8
Transportation	4.4	7.3
Communication	4.8	9.2
Electric, gas, and sanitary services	6.7	8.5
Wholesale and retail trade	6.8	9.0
Finance, insurance, and real estate	6.7	9.0
Services	8.4	8.2
Government and gov't. enterprises	10.8	11.6
Rest of the world	6.5	8.7

In the latter group, the growing importance of part-time workers was responsible for a continuation of the long-term decline in weekly hours.

Higher average hourly earnings, on the other hand, accounted for more than two-thirds of the rise in private payrolls. The 6.3 percent increase in hourly earnings of nonsupervisory workers was substantially greater than the average 4.7 percent rise of 1966 and 1967 and the average 3.2 percent rise during 1961–65.

Government civilian payrolls continued their steady upward trend last year, posting a record gain of $8 billion over 1967. State and local governments were responsible for $5½ billion of this increase as a result of both higher employment and higher rates of pay. After rising early in the year, Federal civilian employment was reduced as part of the program of fiscal restraint passed in late June. For the year as a whole, the employment gain was the smallest since 1964, and the major part of the $2½ billion rise in Federal civilian payrolls reflected higher rates of pay. Military payrolls rose about $2 billion from 1967 to 1968 chiefly as a result of pay increases.

Corporate profits higher

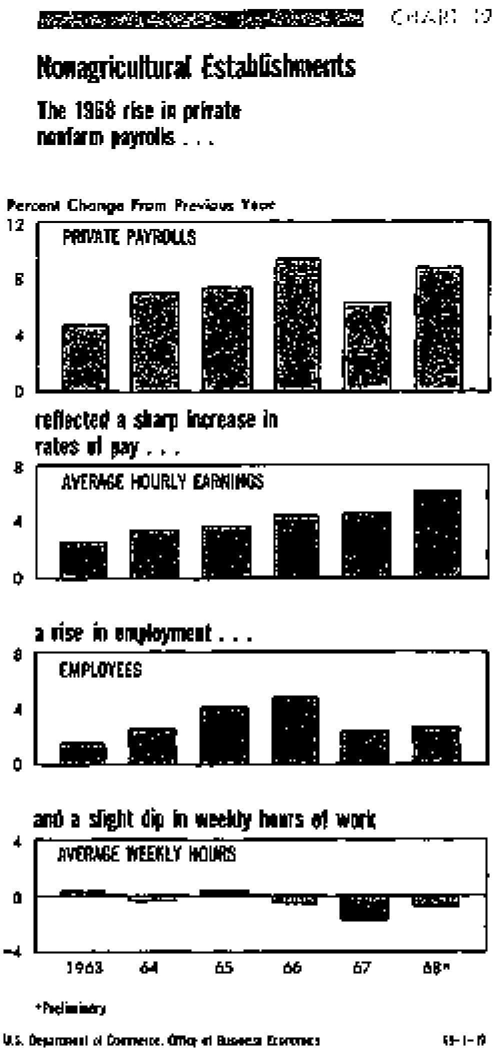
Strong market demands in 1968 permitted a widening of corporate profit margins, and with the volume of corporate output higher, profits before taxes rose sharply. On the basis of data that are still incomplete, before-tax profits rose about $9 billion to a record $89 billion—a development that stands in marked contrast to the $3½ billion decline a year earlier. In relative terms, the rise in profits amounted to 11 percent and, during the current cyclical advance, was surpassed only by the 14¼ percent increase scored in 1965. Profits were higher for all the broad industry groups in 1968, but the rise was most pronounced in manufacturing, particularly durable goods.

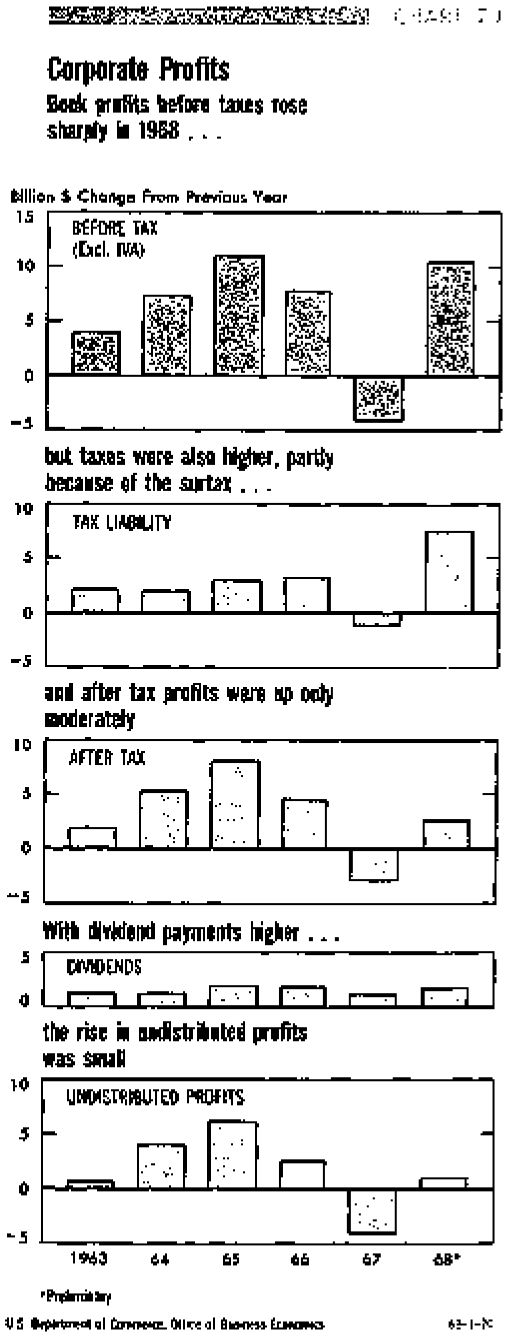
Book profits, which include gains or losses due to differences between the replacement costs of goods taken out of inventory and their recorded acquisition costs, rose even more than the national income version of profits. This was due to the behavior of the inventory valuation adjustment (IVA). With wholesale prices rising more rapidly in 1968 than in 1967, the IVA increased from $1.2 billion to $3.1 billion; consequently, book profits rose $1.9 more than the national income measure.

Corporate tax liabilities rose very sharply in 1968, partly because profits were higher, but mainly because of the increase in taxes resulting from the imposition of the surtax. After-tax profits were only $3 billion or 6 percent higher in 1968 than in 1967. Moreover, with dividend payments rising nearly the same amount as after-tax profits, retained earnings (at $26.4 billion) were only about $1 billion above those of 1967 and were still significantly below their 1966 record high of $29.3 billion. Most of last year's rise in corporate internal funds came from a $4 billion increase in capital consumption allowances.

Industry gains widespread

All industries contributed to the 1968 income rise. The income originating in nearly all the major industry groups was considerably greater last year than in 1967, with most gains falling in the rather narrow range of 7 to 10 percent. Government showed an above-average increase of 11½ percent, and agriculture, a below-average advance of 5 percent. Contrasts with the relative changes in 1967 were most striking in the case of manufacturing, notably durable goods, and agriculture, as may be seen in the table on p. 18.





Labor Markets and Prices

THE year 1968 was the third consecutive year of large price increases and a sharp contrast to the situation in the first half of the 1960's. During the early stages of the upswing that began in the winter of 1961, large annual gains in output were realized with only a slight upward drift in prices. From 1961 through 1965, real GNP increased at an annual rate of 5½ percent, and prices—as measured by the implicit deflator for GNP—rose at a rate of 1½ percent per year. This comparative price stability reflected mainly the continued existence of idle resources of both labor and capital. Unemployment, while tending downward during these years, was still relatively large: 6¾ percent in 1961 and 4½ percent in 1965. At the same time, the rise in average compensation per man-hour, about 4½ percent per annum, exceeded only slightly the gains in productivity, and unit labor costs increased only fractionally each year.

By mid-1965, with the Vietnam buildup superimposed upon civilian demands that were already buoyant, there were signs that the well-balanced business growth that had characterized the preceding years was ending and that the economy was beginning to expand unevenly and in excess of its capabilities. With the rate of advance in total output spurting to over 6¼ percent for the year, these emerging imbalances and inflationary developments intensified in late 1965.

In 1966, pressures on resources mounted, as the advance in real GNP continued at the rapid pace of the previous year. The unemployment rate in 1966 dropped to 3¾ percent. Compensation per man-hour rose more than 7 percent, the growth in productivity slowed, and unit labor costs showed their first sizable increase of the expansion. Mainly because of these cost increases, prices rose more than 2½ percent.

Even though the pace of the output advance slowed considerably in 1967, the unemployment rate-price record for that year was little different from that of 1966. Principally because of large withdrawals from the labor force in the early part of the year, when the business expansion was very slow, the unemployment rate showed no increase as compared with 1966. Average compensation went up somewhat less than the year before, but there was little rise in productivity. Unit costs—labor as well as nonlabor—showed a large advance, much of which was reflected in higher prices.

Labor Markets in 1968

PRESSURES in the labor market were severe during 1968. For the year as a whole, the number of new jobs created outstripped the rise in the civilian labor force, and the number of persons unemployed was reduced.

The unemployment rate, which was already at the unusually low level of about 3¾ percent toward the close of 1967, changed little during most of 1968. However, conditions became still tighter late in the year, and the rate dropped to 3.3 percent in November and December, the lowest ratios recorded since the Korean conflict (chart 21). For 1968 as a whole, the unemployment rate averaged 3.6 percent, a little under the 3.8 percent registered in each of the preceding 2 years.

The demand for labor was extremely strong in 1968, especially for skilled and experienced employees. With the cost of living rising rapidly, with labor's bargaining position very favorable and with several important contracts up for renewal, major contract settlements provided large gains that were an important factor in last year's sharp acceleration in rates of pay. Wage increases were obtained in a setting of considerable labor unrest; the number of strikes was the largest in 15 years and time lost from strikes was the largest since 1959.

Employment totals 76 million

Civilian employment rose 1.5 million last year to 76 million. The size of the employment gain was little different from the advance registered in 1967 but was below the annual increases of 1.8 million in 1965 and 1966. Last year's gain in the civilian labor force came to 1.4 million, less than the rise in 1967 but about average for other recent years.

Annual Changes in Nonagricultural Employment and Sources of Change

[Millions]

Year	Increase in nonagricultural employment	All* sources	Increase in civilian labor force	Decline in unemployment	Decline in agricultural employment
1961	0.2	0.2	0.8	−0.9	0.3
1962	1.2	1.3	.2	.8	.5
1963	1.3	1.3	1.2	−.2	.3
1964	1.7	1.7	1.3	.3	.2
1965	1.9	2.0	1.4	.4	.2
1966	2.3	2.2	1.2	.6	.4
1967	1.6	1.6	1.6	−.1	.1
1968	1.6	1.6	1.4	.2	0

*Total equals increase in the civilian labor force plus the decline in unemployment plus the decline in agricultural employment.

Note: Detail may not add because of rounding.

Source: Basic data from Department of Labor.

In the tight labor market of 1968, adult women accounted for about 55 percent (875,000) of the employment rise even though they accounted for only one-third of the total number of jobholders in 1967. In contrast, adult men filled only about 35 percent (575,000) of the new jobs although they held three-fifths of the jobs the year before. The rise of 100,000 in teenage employment of both sexes was about proportional to their importance in 1967 employment.

The nonfarm sector accounted for all of last year's employment change. After having shown continuous reductions since 1960, agricultural employment last year was about unchanged from 1967. This leveling off further intensified pressures in the nonagricultural job market. During the 1960's the movement of farm workers to nonfarm jobs averaged about 200,000 per annum and, as the table indicates, was an important source of supply for the nonagricultural labor market.

Advance in nonfarm employment

The number of employees on nonagricultural payrolls rose more than 2 million (3 percent) last year to total about 68 million, according to data from nonfarm establishments. The 1968 payroll employment gain slightly exceeded the advance registered in 1967, but was well below the rise of 3.2 million in 1966 and 2.5 million in 1965 (see following table).

Annual Employment Change in Nonfarm Establishments

[Thousands]

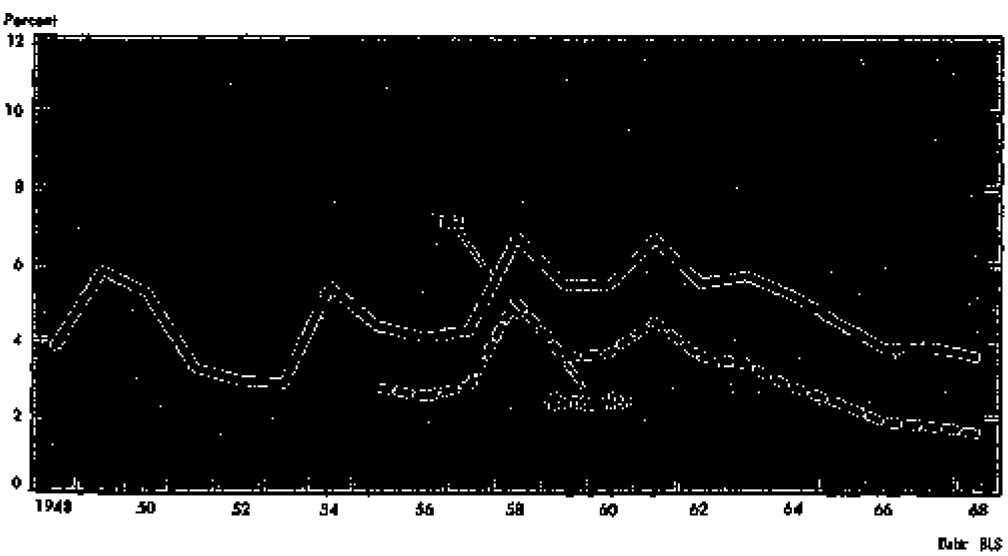
Year	Total	Manufacturing	Private nonmanufacturing	State & local government	Federal Government
1961	−192	−470	27	282	0
1962	1,654	527	731	285	61
1963	1,106	142	629	318	18
1964	1,630	279	960	351	−10
1965	2,500	789	1,217	466	30
1966	3,202	1,162	1,271	603	164
1967	1,996	220	1,081	590	155
1968	2,104	300	1,222	566	17

It may be noted that the 1968 change reported by establishments is considerably larger than employment gains cited earlier, which are based on figures obtained through household surveys. The differences, which have been sizable in recent years, are traceable primarily to two factors. (1) The household survey includes three groups of workers not included in the establishment survey: domestic and other private household workers, the self-employed, and unpaid workers who work 15 hours or more in family-operated enterprises. The number of employees in these three groups has been declining over time, and the drop is usually steepest when other job openings are most numerous. (2) Workers who hold two or more jobs "moonlighters" in nonfarm establishments are counted twice or more often in the establishment survey and only once in the household survey. If the amount of "moonlighting" is increasing, as it apparently does when jobs are easy to find, reported job holdings will go up faster in the establishment survey than in the other.

CHART 21

Unemployment Rates

The overall rate last year was the lowest since 1953



Data: BLS

U.S. Department of Commerce, Office of Business Economics 69-1-21

Gains widespread by industry

Employment in manufacturing rose 300,000 in 1968, to a total of 19¾ million, continuing the expansion in progress since 1962. Although the advance was larger than that of 1967, it was far below the rise of 790,000 in 1965 and 1,150,000 in 1966. Employment gains last year occurred in nearly all of the major durable goods producing industries, with the largest and one of the strongest in transportation equipment; there was also a vigorous advance in ordnance. In contrast, employment for the year decreased slightly in nonelectric machinery, and dropped moderately in primary metals for the second straight year. Employment was also higher in most soft goods industries except for food processing and tobacco.

Private nonmanufacturing industries showed a gain that exceeded 1.2 million and almost matched the record increase of 1966. The largest gains—about 450,000 to 500,000—were registered in the large trade and service groups. Job openings in these industries have been increasing at a swift pace all during the 1960's. The rapidly expanding finance, insurance, and real estate group added 140,000 jobs last year, while employment in transportation rose by 75,000. Employment in the cyclically sensitive contract construction industry increased 50,000 last year, nearly making up the decline experienced in 1967.

State and local government employment continued to rise at a fast pace in 1968, the number of jobs increasing by more than a half million for the third consecutive year. In sharp contrast, however, Federal employment was little changed, after having risen more than 150,000 in each of the preceding 2 years.

Decline in unemployment

With the job gain exceeding the labor force advance in 1968, the number of persons out of work declined nearly 160,000 to a total of 2.8 million persons. The last time the number of unemployed was that low was in the mid-1950's, when the economy (as measured by real GNP) was less than two-thirds as large. For 1967 as a whole, the rise in the labor force exceeded the number of new jobs and unemployment increased by 100,000 persons.

Lower unemployment rates were evident in all the various socio-economic groups. For workers in the prime age-sex group—males 20 years old or over—the rate fell to 2.2 percent; this was only a small improvement from the year before because the rate was already virtually at the frictional level. The unemployment rate for adult women fell from 4.2 to 3.8 percent, while that for teenagers showed only a slight improvement, from 12.9 to 12.7 percent. In 1967, when demand was less pressing, unemployment rates for women and teenagers rose, but the rate for adult men continued to decline.

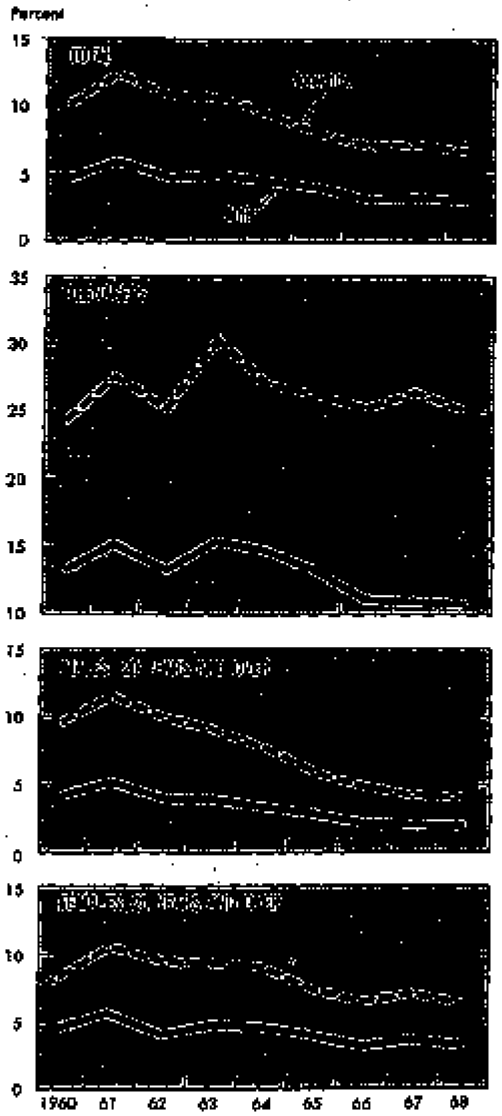
Nonwhite rate still high

The unemployment rate declined relatively more for nonwhite persons than for white persons in 1968. Nevertheless, the rate for the former continued to be double that for the latter; the problem is especially acute among nonwhite teenagers, whose unemployment remained at 25 percent last year. Moreover, the nonwhite unemployment rate has not improved much relative to the white rate over this decade.

CHART 22

Unemployment Rates

- Both white and nonwhite rates have been cut sharply during the 1960's
- Nonwhite rates remain substantially above white



Data: BLS

U.S. Department of Commerce, Office of Business Economics 69-1-22

As chart 22 shows, unemployment rates for both whites and nonwhites in each of the major age-sex groups have fallen substantially since 1961, when the overall rate stood at 6⅝ percent. In 1961, at the beginning of the current business expansion, the unemployment rate for nonwhites (12⅜ percent) was a little more than twice that of whites (6 percent). Last year, the rate for both groups was substantially lower. The nonwhite rate (6¾ percent) was still somewhat more than double the white rate (3¼ percent) but a relative improvement is evident for adult males. It should be noted that despite lower rates, white unemployment, at a little over 2 million in 1968, was still substantially greater than nonwhite unemployment, which averaged about 600,000.

Rates of pay higher

Increases in rates of pay accelerated sharply in last year's tight labor market. Average hourly earnings in private industries scored a 6.3 percent advance, as a result of widespread gains that exceeded those of any other year in the present decade (see table).

The 1968 increases were the result of wage increases for nonunionized workers, statutory increases under the Federal minimum wage law and substantial settlements under union contracts. Labor contracts were negotiated for at least two-fifths of the 10.7 million workers covered by major collective-bargaining agreements. According to the Labor Department, the contracts settled during 1968 provided a median first-year wage rate adjustment of 7.5 percent of straight-time hourly earnings. This gain substantially exceeded the 5.6 percent increase under settlements concluded in 1967 and the 4.8 percent increase of 1966. The first-year changes of the 1968 settlements are "front-end loaded" to a considerable degree, since the wage change over the entire life of the contracts is 5.1 percent, only slightly above the 1967 figure. The emphasis on the large first-year figure apparently reflects labor's concern over the rapid price rise.

Percent Increases in Average Gross Hourly Earnings of Production or Nonsupervisory Workers

	1960-61	1961-62	1962-63	1963-64	1964-65	1965-66	1966-67	1967-68
Total private [1]	2.4	3.7	2.7	3.5	3.6	4.5	4.7	6.3
Manufacturing	2.7	3.0	2.9	2.6	3.2	4.2	4.0	5.4
Nondurable	2.9	2.3	2.8	3.2	3.1	3.6	4.9	6.6
Durable	2.5	2.8	2.7	3.0	3.0	3.9	3.4	5.3
Construction	3.9	3.4	3.0	4.1	4.2	5.1	5.7	6.3
Mining	1.1	2.3	1.9	2.2	3.9	4.5	4.6	4.7
Trade	2.9	4.0	3.3	3.7	3.6	4.9	5.6	6.7
Retail	2.6	4.5	3.1	4.2	4.0	4.9	6.2	7.6
Wholesale	3.1	2.6	3.4	2.9	3.6	4.6	5.5	5.9
Finance, insurance, and real estate	3.6	3.3	3.7	2.2	3.0	3.3	4.5	6.6

[1] Includes industry divisions not shown separately.

Source: Basic data, Bureau of Labor Statistics, U.S. Department of Labor.

Price Developments in 1968

WIDESPREAD price increases characterized last year's full-employment economy. A combination of higher aggregate demand, rising costs of production, and a buildup of inflationary expectations led to the most sizable overall price rise since the 6 months following the outbreak of the Korean war. Moreover, if not for the excess production capacity in some basic industries such as steel and cement and the availability of competitively priced imported goods, the price increases of 1968 would have been still greater.

Not all of last year's price rise was a reflection of rising demand under full-employment conditions. Farm prices are a significant case in point. These prices, which had declined in 1967 and helped to offset the rise in the nonfarm sector, turned around and added to the general price advance in 1968.

The prices of goods and services included in the GNP rose approximately 1 percent in each quarter of 1968 and averaged 3¾ percent higher than in 1967. For the year as a whole, consumer prices showed an advance of more than 4 percent following a rise of nearly 3 percent in the preceding year. Prices in wholesale markets rose 2½ percent last year, after little change from 1966 to 1967.

Corporate Prices and Costs

A useful analysis of price-cost-profit relationships is afforded by data for nonfinancial corporations, which produce a large share of the GNP and which have clear-cut distinctions between wages and profits. (The latter is not true of nonincorporated business.) The data provide a link between the flow of labor and nonlabor income, on the one hand, and the real volume of output, on the other. Costs and profits per unit of production are obtained by dividing each income and nonincome aggregate measured in current dollars—profits, employee compensation, capital consumption allowances, etc.—by the total production of these corporations measured in constant 1958 dollars. The sum of the costs and profits per unit equals price per unit, which is the deflator for nonfinancial corporations.

Real corporate output rose 6 percent in 1968—a noteworthy recovery from the small 1½ percent gain from 1966 to 1967. Corporate prices rose close to 3 percent, reflecting not only expanded profit margins but also higher costs. The 1968 price rise was only slightly more than the rise the year before, but well above the increases in any other year of the current expansion.

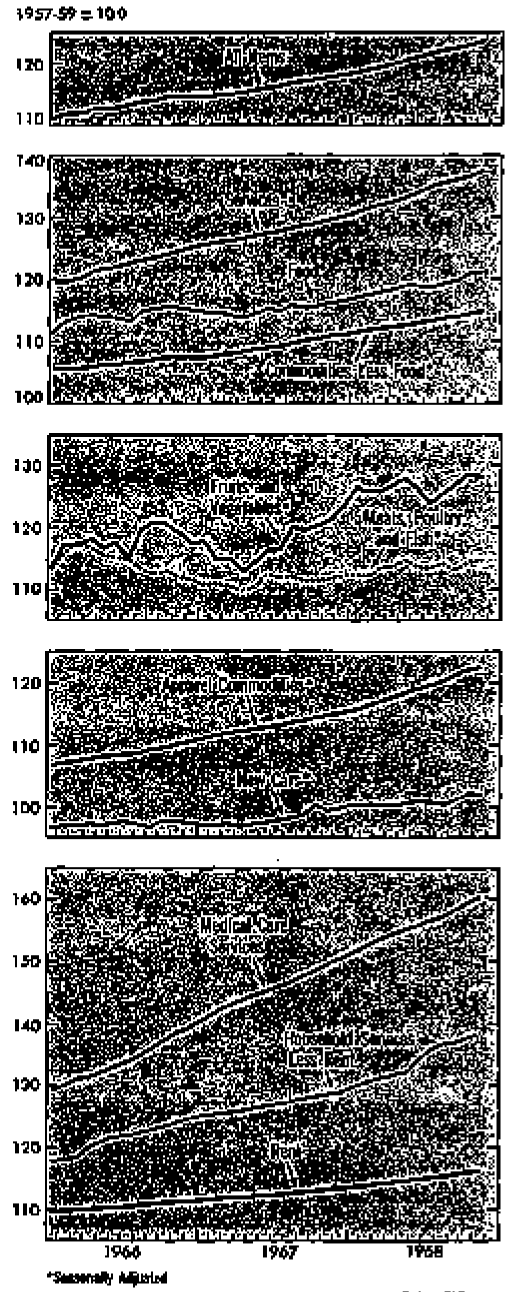
The components of price change in 1968 were different from those in 1967 even though the overall advance in prices was not much different. Last

CHART 23

Consumer Prices

*Consumer prices in late 1968 were 4 ¾ percent above a year ago

• Increases ranged from 6 percent for services to 4 percent each for food and nonfood commodities



*Seasonally Adjusted

Data: BLS

U.S. Department of Commerce, Office of Business Economics 69-1-13

year witnessed a rise in unit labor costs that was well below that of 1967: about 2.7 percent as compared with 4.3 percent. The deceleration in the rise in unit labor costs in 1968 occurred despite the substantial increases in rates of employee compensation. This reflects the fact that higher labor productivity (output per man-hour) offset the increases in employee compensation to a greater extent in 1968 than in 1967.

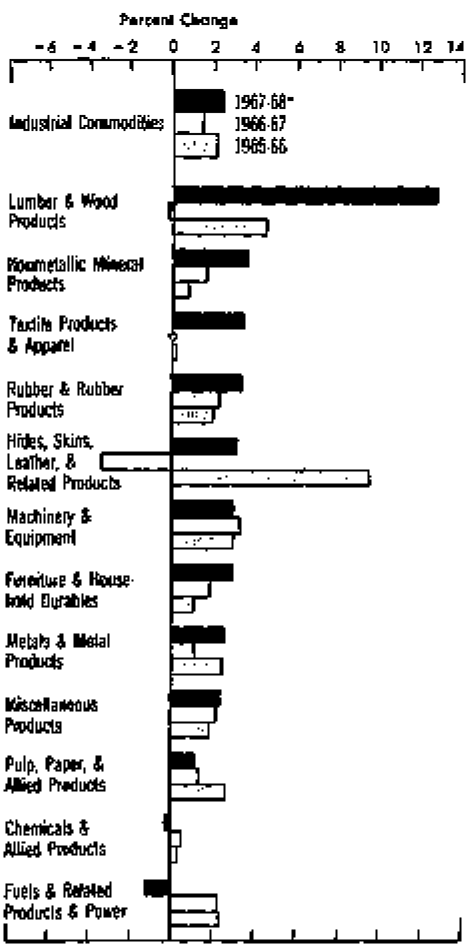
In addition to less growth in unit labor costs, the rise in the nonlabor component of unit costs also slowed markedly in 1968. These costs, which include primarily capital consumption allowances, indirect business taxes, and interest, are relatively fixed in the short run. Nonlabor costs per unit of corporate output rose 2.2 percent in 1968 as compared with a 7 percent increase in 1967.

Finally, the increase in the unit price of corporate output in 1968 differed from that of 1967 with respect to the role of profit margins. In 1967, when demand conditions were less buoyant, corporations were forced to absorb part of their sharply higher unit costs in the form of lower profit margins, which declined about 7¾ percent. Last year, however, the reverse of the 1967 situation prevailed. Strong market demands permitted corporations to raise unit prices more than the unit cost increases, and profit margins rose about 4¾ percent.

These developments are illustrated in chart 25, where the year-to-year changes are shown in absolute rather than percentage terms. The chart makes clear that last year, higher labor costs accounted for somewhat more than half the price rise; in the 2 preceding years, labor costs on balance accounted for almost all of the price rise.

Wholesale Industrial Commodity Prices

- Prices of wholesale industrial commodities rose 2½ percent from 1967 to 1968
- For most commodity groups increases were larger than in 1967



*Percentage change figures are based on annual average data, with December 1968 estimated.

Data: BLS

U.S. Department of Commerce, Office of Business Economics

Consumer Prices

Prices of virtually all consumer goods and services rose in 1968, unlike 1967, when near-stability in food prices dampened the rise in the overall index. Service prices generally showed the largest advances, ranging from about 2½ percent for rent to nearly 7½ percent for medical care. Prices of consumer commodities averaged 3¾ percent above 1967 with about equal increases in food and nonfood.

Food prices rebound

Retail food prices advanced last year despite improved supplies of many items. Prices in grocery stores were up more than 3 percent after a small decline in 1967, and prices of restaurant meals increased more than 5 percent. The rise in restaurant prices reflects not only the higher cost of food prepared by such establishments but also a substantial boost in employee pay scales—in part a result of the extension of minimum wage coverage early in the year.

Changes in retail grocery store food prices were in sharp contrast to 1967. Two groups that account for more than one-half of consumer food purchases—meats, poultry, and fish, and "other foods at home" (which includes such important commodities as margarine, cooking oil, eggs, sugar, and coffee)—rose almost 2¾ percent after sizable decreases in 1967. In contrast, prices of cereals and bakery products and dairy products increased less than in 1967. The most significant contribution to the rise in food prices last year came from fruits and vegetables. These products, which account for roughly one-sixth of the food index and were unchanged from 1966 to 1967, showed an average price advance of 7¾ percent from 1967 to 1968. A sharp rise in citrus fruit prices last winter, due to a freeze that reduced supplies, accounted for the bulk of the increase.

Nonfood commodity prices up

Prices of consumer goods other than food rose 3¾ percent from 1967 to 1968, after increases of 2½ percent in 1967 and 1¾ percent in 1966. Last year's increases for nondurable goods averaged more than 4 percent, while those for durables were about 3 percent. Rising apparel prices were an important part of the broad advance for nondurables; retail prices of clothing and shoes were boosted almost 6 percent last year, the largest rise since the scare buying that followed the start of the Korean war.

The price rise for consumer durable goods last year was a continuation of a pronounced upward trend that started in early 1967 after several years of comparative stability. New car prices were up 3 percent from the year-earlier average, reflecting the increases posted on both the new 1968 models in late 1967 and the new 1969 models introduced last September. Prices of household durables rose 3¾ percent last year after a 1½ percent advance in 1967.

Service price rise continues

Service prices continued to be the most rapidly rising component of the

Consumer Price Index. For all services, prices rose 3¾ percent in 1966, 4½ percent in 1967, and 5½ percent last year; if rents are excluded, each of these figures would be increased by about one-half of 1 percent. To a large degree, service price changes reflect changes in labor costs. The tight labor market, higher minimum wage rates, and extended minimum wage coverage have all been important factors contributing to the upward movement of wages and prices in service industries.

Prices of medical care services continued their pronounced rise in 1968, but the tempo of the advance eased somewhat from the 8¾ percent rate of 1967, the first full year of medicare. However, last year's 7½ percent increase was the largest among the major service categories, as doctors' fees advanced, hospital room charges soared, and health insurance premiums were adjusted upward to keep pace.

Price rises for most other services were also substantial in 1968. Household services, excluding rent, rose nearly 6 percent, partly because of sharply higher mortgage interest costs; transportation services were up 4 percent, and prices of miscellaneous services, such as haircuts, movie admissions, and college tuition fees, increased an average of 5½ percent. The rise in rents accelerated with a boost of 2¼ percent; the acceleration reflects mainly the pressure of demand on the comparatively limited supply of apartments, as evidenced in the steady decline in rental vacancy rates.

Estimated Contribution to Rise in the Consumer Price Index by Major Groups

	1965–66	1966–67	1967–68
Major groups:			
Food	1.14	0.21	0.81
Housing	.79	.50	1.34
Apparel and Upkeep	.27	.42	.57
Transportation	.19	.36	.46
Health & Recreation	.57	.78	.99
Special groups:			
Commodities	1.70	1.17	2.30
Food	1.14	.21	.81
Nondurable except food commodities	.57	.76	1.01
Apparel commodities	.24	.37	.52
Other nondurables less food and apparel	.33	.38	.61
Durable commodities [1]	.02	.28	.65
Household durables	−.01	.07	.17
New cars	−.04	.02	.07
Services	1.31	1.54	1.83
Rent	.06	.10	.13
Household services less rent	.52	.62	.82
Transportation services	.21	.17	.20
Medical care services	.25	.43	.38
Other services	.22	.23	.33
All Items	2.0	2.8	4.2

[1] Includes items not shown separately.

NOTE.—Contribution is measured by price change times relative importance of the component in December of the preceding year. Details will not add to subtotals or totals.

Source: Basic data from BLS.

The text table shows, for each of the major components of the Consumer Price Index, the contribution to the price rise in each of the past 3 years. The contribution is measured by the price change times the relative importance of the component.

Wholesale Prices

Prices in wholesale markets increased 2½ percent from 1967 to 1968, after little change the preceding year. Prices of industrial and agricultural commodities showed about equal gains, in contrast to 1967 when a moderate rise for industrial products was about offset by declines in farm products and foods. The advance in industrial commodity prices for the full year 1968 was the largest in a decade and was broadly based: Of the 12 major industrial commodity groups in the Wholesale Price Index, 10 registered increases. Prices of farm products and processed foods reversed their 1967 decline with increases in both crops and livestock.

Agricultural commodities higher

On a combined basis, prices of farm products, processed foods, and feeds advanced 2½ percent in 1968 after a somewhat higher drop the preceding year. The rise in farm product prices slightly exceeded that for foods and feeds combined; in the latter category, prices of manufactured animal feeds weakened as a result of reduced exports and little change in domestic demand. Bumper crops of food and feed grains, both in the United States and abroad, led to a decline of 11 percent in domestic grain prices last year; this was the only significant reduction among the major agricultural commodity groups (see table). Improved demand bolstered prices of livestock and meats about 3½ percent, after marked declines in 1967, and prices of fruits and vegetables, both fresh and processed, were up 6½ percent last year.

Changes in Wholesale Prices of Farm Products and Foods

[Percent]

	1965–66	1966–67	1967–68
Farm products, processed foods, and feeds	6.7	−2.4	2.3
Farm products	7.3	−6.0	2.5
Fruits and vegetables, fresh and dried	.7	−.9	6.6
Grains	8.6	−6.3	−10.8
Livestock	9.5	−8.1	3.7
Poultry	5.8	−10.1	3.5
Processed foods and feeds	5.9	−1.2	2.1
Fruits and vegetables, canned and frozen	2.6	2.3	0.5
Cereals and bakery products	5.9	1.5	.0
Meats, poultry, and fish	9.1	−4.7	3.1
Dairy products	0.2	3.0	4.6

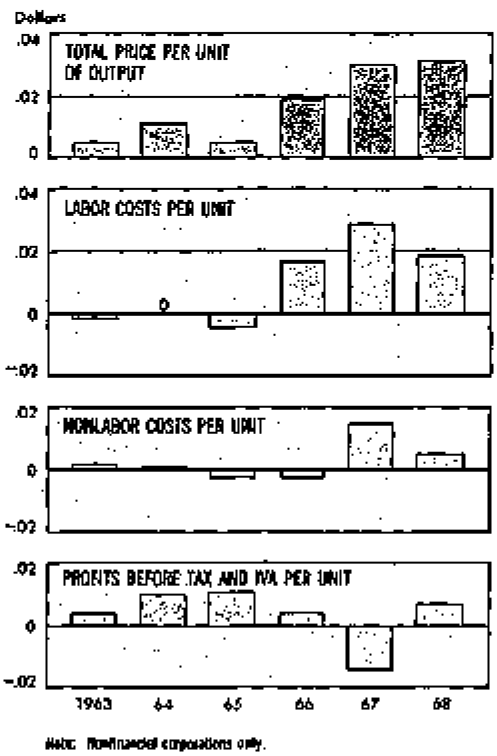
Industrial prices increase

Wholesale prices of industrial commodities—a key measure of price trends—showed widespread and generally substantial increases last year.

(*Continued on page 32*)

Changes in Prices, Costs, and Profits Per Unit of Real Corporate Output

Last year's price rise for corporations reflected increases in labor costs, nonlabor costs, and profit margins



Note: Nonfinancial corporations only.

U.S. Department of Commerce, Office of Business Economics 69-1-25

Financial Developments in 1968

THE strong rise in economic activity last year brought increased demands to credit markets that were already under stress as the year began. Governments were unusually large borrowers in 1968. State and local governments issued a record volume of new securities, and the Federal Government issued new securities in amounts close to last year's postwar record. Consumers increased their borrowing in 1968 markedly: Additions to mortgage debt were almost one-fifth higher and additions to installment debt more than 2½ times as large as the increases the year before. Corporate business remained heavily dependent on external financing last year as the rise in internal funds failed to keep pace with the expansion in investment expenditures. The funds raised by corporations in credit markets in 1968 were second only to the record amounts borrowed in 1967.

The strains that these heavy demands for funds imposed on credit markets were accentuated by a restrictive monetary policy. In an attempt to contain inflationary pressures and promote orderly economic growth, the Federal Reserve System pursued a monetary policy designed to provide a limited accommodation of unusually large credit demands. Although restrictive in relation to the demands for funds, this policy, which varied in its intensity at different times within the year, permitted substantial growth in bank credit, money supply, and time deposits.

Interest rates and bond yields

Despite strong growth in monetary variables in 1968, the pressures that developed in financial markets produced the highest annual levels for financing costs in several decades. Long-term rates, which had advanced from 1966 to 1967, rose still further last year, and short-term rates, which had fallen in 1967, rose to new records (chart 26). Interest rates and bond yields exhibited erratic patterns during 1968 as they responded to a variety of influences—the uneven impact of credit restraint, the gold crisis in the spring, uncertainties associated with the passage of the program of fiscal restraint, anticipations of continued inflation, and the shifting prospects for peace in Vietnam. On balance, financing costs rose over the first 5 months of 1968 and by the end of May had exceeded the highs established in 1966 and 1967. Following the passage of tax legislation and the ensuing relaxation of credit tightness, financing costs fell noticeably through midsummer but rose again in the fall. The upward trend in financing costs gathered momentum in December when commercial banks twice raised their prime rates, and the Federal Reserve System raised the discount rate. By yearend, most interest rates and bond yields had risen above their end-of-May peaks.

Monetary policy

During the first half of 1968, the burden of dampening the economic expansion fell on monetary policy. Following the shift from expansive credit policies in late 1967, which the Federal Reserve System signaled with increases in both the discount rate and the reserve requirements on demand deposits, the authorities moved gradually toward tightening in the early months of 1968. In the spring months, faced with the strong evidence of an acceleration in inflationary pressures, and the outbreak of the gold and dollar crisis, the authorities used monetary policy more forcefully. The discount rate was raised from 4½ to 5 percent on March 22 and again on April 19 to 5½ percent. Although the System made substantial purchases of Government securities through its open market operations, these were limited to offsetting the loss of reserves that resulted from gold sales. Also, especially from mid-March to mid-April, the System imposed considerable restraint on the banking system by delaying action to raise the interest rate limits that Regulation Q allowed banks to pay for time deposits. With market rates of interest rising, banks were experiencing considerable difficulty in attracting and holding these deposits, a particularly acute problem in the case of the large denomination certificate of deposit funds.

During the summer, after the passage of the program of fiscal restraint, the tempo of credit policy changed again. Concerned with the possibility that the late June tax and expenditure legislation might lead to an overdose of fiscal restraint, and seeking to establish a better mix between monetary and fiscal policies, the Federal Reserve made heavy open market purchases of Government securities. This permitted an expansion in bank reserves that helped ease credit conditions considerably. On August 15, the discount rate was lowered from 5½ to 5¼ percent.

In the fall, when it became evident

that consumer and business spending were not slowing down as anticipated, credit restraint was stepped up. In the closing months of the year, open market operations held the line on the expansion in member bank reserves, rising market rates of interest were again bringing the banks under pressure from Regulation Q ceilings, and on December 18, the discount rate was returned to its pre-August level of 5½ percent.

Bank credit expansion

The credit policy pursued in 1968 permitted an expansion in member bank reserves that provided an increase of 11 percent in commercial bank credit. This was only slightly less than the postwar record increase of 1967 when stimulative credit policies prevailed, and it was twice as large as the 5½ percent advance in 1966, the last experience with credit restraint. Following the pattern of monetary policy noted above, bank credit expansion was uneven over the course of 1968: loans and investments at commercial banks rose at a moderate 6½ percent annual rate in the first two quarters, spurted to a record 19 percent annual rate in the summer and then tapered to a 10½ percent rate in the fourth quarter.

Loans at commercial banks increased $27 billion last year and accounted for about 70 percent of the total expansion in bank credit. This contrasts with the year before when, under less buoyant conditions, commercial banks allocated more than half of their portfolio increases to investments in U.S. Government and other securities. Despite the limitations of monetary policy, loans at commercial banks were relatively strong in the first half of 1968 as banks relied on the liquidity they had built up in 1967 and supported loan expansion by curtailing their investments in securities. Loan expansion accelerated sharply in the summer quarter, but subsided a little in the closing quarter of the year.

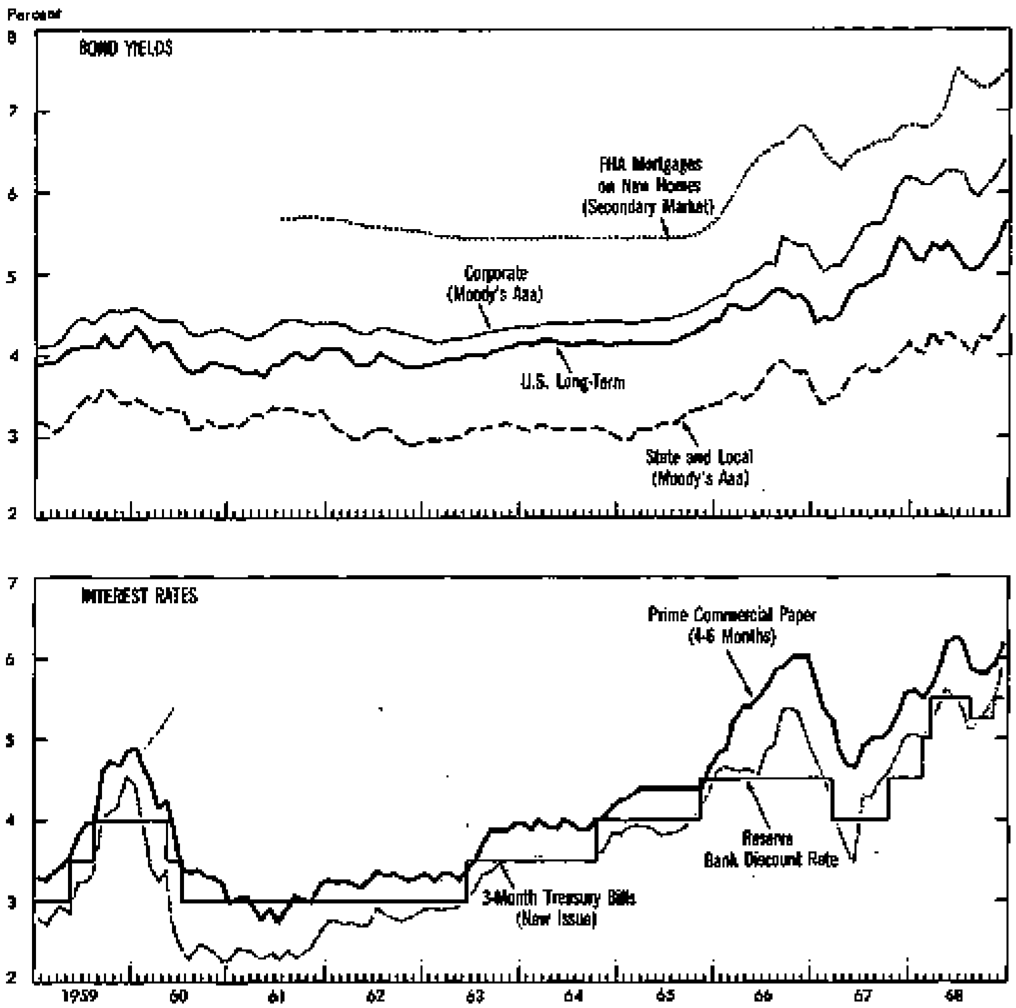
The investment component of bank credit rose $11 billion in 1968, roughly half of the advance posted in 1967. By far the largest part of last year's increase ($8 billion) was recorded in the second half of the year, and most of this was concentrated in the summer quarter. For the year as a whole, most of the commercial bank investments were in State and local obligations as banks added only $2 billion to their holdings of U.S. Government securities.

Bank deposit expansion

Total deposit liabilities of commercial banks mirrored the strong expansion in bank credit and rose 9½ percent last year. The money stock (currency and demand deposits) increased 6½ percent in 1968, about the same as in 1967, but the 11½ percent expansion in time deposits was substantially less than the advance in the preceding year.

Increases in time deposits were smallest in the spring, largest in the summer and tapered slightly in the fall. These variations reflected the unevenness of monetary restraint last year, as well as shifts in the public's preferences for holding time deposit balances. The latter, in turn, was related to the movements in market rates of interest and to the relationship these bear to the maximum ceiling rates that Regulation Q allows the banks to pay for time deposits. In late winter and spring, when restraints were greatest, the rapid rise in market rates of interest reduced the attractiveness of the rates paid on time deposits, and interest-sensitive depositors shifted from these deposits to higher yielding market securities. In the summer, when credit restraint was relaxed and market rates of interest receded, this process was reversed and time deposit growth accelerated. In late fall, the strong rise

In 1968, financing costs reached their highest levels in several decades



U.S. Department of Commerce, Office of Business Economics

Data: FRB, FHA, Moody's & Treas.
69-1-16

in interest rates was apparently again causing a shift in the public's preference for holding time deposit balances, and growth in these deposits moderated.

While the expansion in money stock was rapid throughout last year, it was particularly pronounced during the spring. After rising at a seasonally adjusted annual rate of 4½ percent from January to March, the growth in money stock surged to an 8½ percent rate in the second quarter, tapered to about half this pace in the summer and then rose at nearly a 7½ percent rate in the closing quarter of the year. In a general way, these changes were the reverse of those shown by time deposits.

The unusual acceleration in money expansion in the spring resulted in part from the public's decision to shift the flow of new deposits from time to demand deposits. As explained above, this was a consequence of the changing spread between market rates of interest and the rates that Regulation Q permitted banks to pay on time deposits. It was also a consequence of a strong demand for money balances that developed at this time. This demand is believed to have been related to the sharp step-up in the volume of stock market activity and the accompanying log jam in paperwork—and to a variety of uncertainties: the gold and dollar crisis, the outlook for fiscal restraint, and the course of monetary policy and interest rates. Thus, with the demand for money strong and for time deposits weak, the deposit creation that did occur during the spring mainly took the form of demand deposits. In addition, the pronounced second quarter acceleration in money stock was partly the result of a marked shift from Government demand deposits (which are not counted as part of the private money stock) to private accounts.

The growth of demand deposits slowed appreciably in the summer when time deposit growth accelerated and government deposits built up. During the fall, the pickup in money growth reflected a reversal of these developments: Government demand deposits were reduced and the public again devoted a somewhat larger proportion of deposit growth to money balances and a smaller proportion to time deposits (see table).

Quarterly Changes in Reserves and Deposits of Member Banks, 1968

[Seasonally adjusted, billions of dollars]

	I	II	III	IV
Total reserves	0.66	0.01	0.58	0.56
Nonborrowed reserves	.29	−.02	.63	.19
Total deposits*	4.9	.9	6.1	9.0
Demand deposits	1.5	3.1	.4	3.3
Time deposits	1.3	.6	7.1	6.9
Government deposits	2.1	−2.8	−1.4	−1.2

*Deposits subject to reserve requirements.

(*Continued from page 29*)

Within the year, prices advanced sharply during the winter months, leveled off through August, and began to rise again in the fall. The period of stability during the summer resulted from a retardation in the rate of price increases for most commodity groups and a decline in prices of metals.

Among the major commodity groups, the most prominent advance was the 13 percent rise in lumber and wood products, which have a weight of only 3½ percent in the overall industrial index. Eight groups with a weight of 70 percent in the Industrial Price Index showed increases ranging from 2½ to 3½ percent. Among these, the most important were the increases in such heavily weighted categories as textile products and apparel, metals and metal products, and machinery and equipment.

Wholesale prices of textile products and apparel had fluctuated in an extremely narrow range for nearly 15 years prior to late 1967, mainly because of the pronounced expansion in the capacity of manmade fibers and the competition from imports. In 1968, however, prices of textile products and apparel rose 3½ percent as manmade fiber prices firmed and prices of cotton products advanced.

Metals prices moved erratically in 1968 but, on balance, averaged 2½ percent above their 1967 level, about double the rise in the preceding year. The 3½ percent rise in the index of nonferrous metals prices was closely associated with the copper situation. Domestic copper production was shut down by a strike that began in mid-1967 and extended into April 1968. Prices of secondary copper products increased substantially during the strike period, but dropped sharply after a settlement was reached. Domestic producers raised primary copper prices at the end of the strike and again at yearend.

Iron and steel prices were somewhat unstable during 1968; producers increased prices of some key products after a new labor contract was concluded on July 31, but a substantial reduction—partially rescinded—was made on hot-rolled sheets in the fall. Declines in steel scrap prices during 1968 accompanied the decline in steel production after late spring and held the rise in the overall index of iron and steel prices to 2 percent.

Machinery prices continued to rise at the 3 percent rate of the 2 preceding years. Increases were sizable for all categories except electrical machinery. Prices of motor vehicles and equipment rose 2¾ percent in 1968 after a 1½ percent increase the preceding year.

The rise in the overall index of industrial commodity prices was dampened last year by a reduction in fuel prices and near-stability in chemical prices; together, these commodities constitute nearly one-fifth of the industrial index. The drop in fuels reflects mainly declines that have occurred in refined petroleum product prices since their sharp runup in mid-1967 at the time of the Middle East conflict; these were offset to some extent by higher coal prices. Chemical prices eased a little because of price-cutting in agricultural chemicals and fertilizers, where capacity has been excessive.

The Balance of Payments in 1968

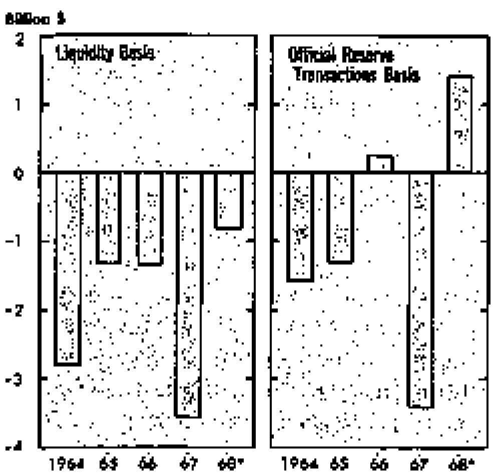
THE pattern of our international receipts and payments in 1968 was notably different from the pattern of previous years, reflecting unusual changes in trade and capital transactions. Even though exports rose substantially, a new upsurge in imports caused a pronounced decline in our merchandise trade surplus. In an even more striking development, the United States became a net importer of capital in 1968. This change on capital account more than offset the deterioration in the trade balance, resulting in a liquidity balance more favorable than in any other year since 1957.

The year 1968 began in a climate of uncertainty in financial markets. There were lingering doubts as to the strength of the dollar after Britain's failure in late 1967 to maintain the exchange value of the pound. In order to restore confidence in the dollar and in the international monetary system, the President announced a broad program on January 1, 1968, to improve the balance of payments. The program included mandatory restraints on direct investment abroad, tighter measures restraining foreign lending by banks, and further efforts to reduce the adverse impact of Government expenditures.

Before the effects of these measures were fully demonstrated, speculative purchases of gold, which had been very heavy in the fourth quarter of 1967, reached crisis proportions again in March. U.S. gold losses in the first quarter were nearly $1.4 billion, most of which was used to meet private demand in foreign gold markets. This loss was brought to a halt after the international agreement of March 17 to stabilize official gold reserves. The agreement to stop supplying gold from official reserves to private markets meant that private demand and supply (including new production) would determine the price of gold traded there. At the same time, the price at which gold was to be traded among official agencies was maintained at $35 per ounce.

The two-tier price system for gold was remarkably successful in halting the speculative attack on the official gold price. Uncertainty over the strength of the dollar disappeared before midyear, and the dollar remained relatively strong on the exchange markets in the face of speculation over the defensibility of existing exchange rates for the German mark and the French franc.

U.S. Balance of Payments



*January-September totals, seasonally adjusted.

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Later in the year, speculative movements of funds out of France for investment in German marks placed extreme strains on international financial markets. Although the U.S. dollar was not under pressure during these disruptions, the defensive measures employed by foreign countries in protecting their currencies and the support extended them by the United States led to significant changes in the composition of U.S. official reserves and in U.S. liabilities to foreign official agencies.

In the process of supporting their currencies, foreign official agencies made massive use of their liquid dollar holdings, including those obtained through swap arrangements with the United States and through their drawings of dollars from the IMF. During the course of the year, these support operations affected U.S. accounts by (1) reducing U.S. liquid liabilities to foreign official agencies, (2) increasing U.S. liquid liabilities to private foreigners, (3) increasing U.S. official reserve assets held in the form of convertible currencies, and (4) improving the U.S. gold tranche position in the IMF.

Changes in balances

During the full year 1968, the U.S. reserve position in the IMF and the convertible foreign currencies included in U.S. official reserves increased by $2.1 billion, more than offsetting the net reduction of $1.2 billion in the gold stock. Thus, total U.S. official reserve assets, although changed in composition, showed a net increase of $0.9 billion during 1968.

During the first 9 months of 1968, there was a net decrease of $1.9 billion in U.S. liabilities to foreign official agencies. This reflected reductions of $3.6 billion in liquid liabilities offset, in part, by an increase of some $1.7 billion in nonliquid liabilities, including special financial transactions designed to convert U.S. liabilities to foreigners from liquid to nonliquid form. The net reduction in U.S. liabilities to foreign official agencies for the full year plus the increase in U.S. official reserve assets created a large surplus in the balance measured on the official reserve transactions basis, as compared with a deficit of $3.4 billion on this basis in 1967.

Since the balance on the liquidity basis is not affected by the shift of liquid dollar liabilities from official to private accounts, this measure of the balance of payments was less influenced by the emergency financial operations abroad. The improvement in the liquidity balance, therefore, reflected principally the large inflows through foreigners' net investments in the United States, including purchases of U.S. stocks, bonds, and other nonliquid assets. These contributions, together with a rise in receipts from special transactions by foreign official agencies (up from less than $1.0 billion in 1967 to more than $1.4 billion through September 1968), more than offset the serious deterioration in the U.S. trade balance. In the first 9 months of 1968, the total liquidity deficit was only $0.8 billion, seasonally adjusted, and the final total for the full year may have been more favorable. The comparable deficit was $3.6 billion for all of 1967 and about $1.3 billion in 1965 and 1966 (chart 27).

Merchandise Trade

On the basis of incomplete data for the whole year, the Nation's favorable trade balance appears to have dropped from $3½ billion in 1967 to barely $½ billion in the year just ended. (On the Bureau of Census basis, the balance fell from $4.1 billion to 1967 to $1.1 billion in 1968.) The export surplus of $½ billion was the narrowest in the whole post-World War II period, and the year-to-year deterioration of $3 billion was the largest adverse shift since 1949–50.

These developments occurred against a background of vigorously expanding trade in both directions last year. Nonmilitary merchandise exports in 1968 rose 11 percent over the preceding year after a gain of only 4½ percent for 1967, while imports increased 23 percent following a 1967 advance of less than 6 percent.

Actual or threatened strikes in domestic metal industries and by longshoremen at east and gulf coast ports distorted quarterly trends in trade during 1968 and strongly influenced the statistics for specific commodities like steel, copper, and aluminum. However, their effect on the movement of overall exports, imports, and the trade balance for the year as a whole was not of major importance. With realistic assumptions as to the effects of these special factors on the annual volumes of imports and exports, it appears unlikely that much more than one-fifth of the deterioration in the trade balance in 1968 could be attributed to strikes and the threat of strikes.

Sharp rise in imports

The exceptionally large rise in imports in 1968 was reflected in all major categories of goods. Industrial supplies and materials accounted for about 40 percent of the total dollar gain in imports, reflecting demands sparked by the swift pace of U.S. economic growth and amplified by strikes or threats of strikes. Nevertheless, the rate of increase in this major category was less rapid than the gain in total imports. Automotive vehicles and parts, on the other hand, which accounted for about one-tenth of total 1967 imports, contributed one-fourth of the 1968 expansion in total imports. Imports of other nonfood consumer goods advanced at a pace about parallel with the overall rate, with strong growth widespread throughout this group of commodities. Although imports of foods and beverages advanced less rapidly than the total, 1968 witnessed a sharp reversal in coffee imports from the 1967 downturn, while imports of whiskey and meat products extended the sizable gains of recent years.

At the same time, total agricultural exports showed almost no expansion from 1967. Gains in exports of corn, cotton, and tobacco were largely offset by lower exports, mainly of sorghums but also of wheat and other grains. Reductions in grain prices accentuated the declines in agricultural export values.

Among nonfarm products, annual gains were substantial for exports of transport equipment, chemicals, and forest products. However, there were some significant shifts within the year. Sharply increased worldwide deliveries of commercial transport planes, together with strongly expanding automotive sales to Canada, accounted for nearly half the seasonally adjusted gain in total exports from the last half of 1967 to the first half of 1968. These two commodity groups accounted for less than one-fifth of the advance in overall exports in the second half of 1968. The latter period brought expanded gains in exports of chemicals, wood and paper, and nonferrous metals (following labor-contract settlements) and marked increases in exports of machinery and nonfood consumer goods.

Except for the stepped-up pace of automotive deliveries, exports to Canada showed little growth in 1968. Exports to Western Europe showed significant improvement, expanding sharply in the second half of the year, and sales to Japan in the second half also bettered the already improved performance of the first half.

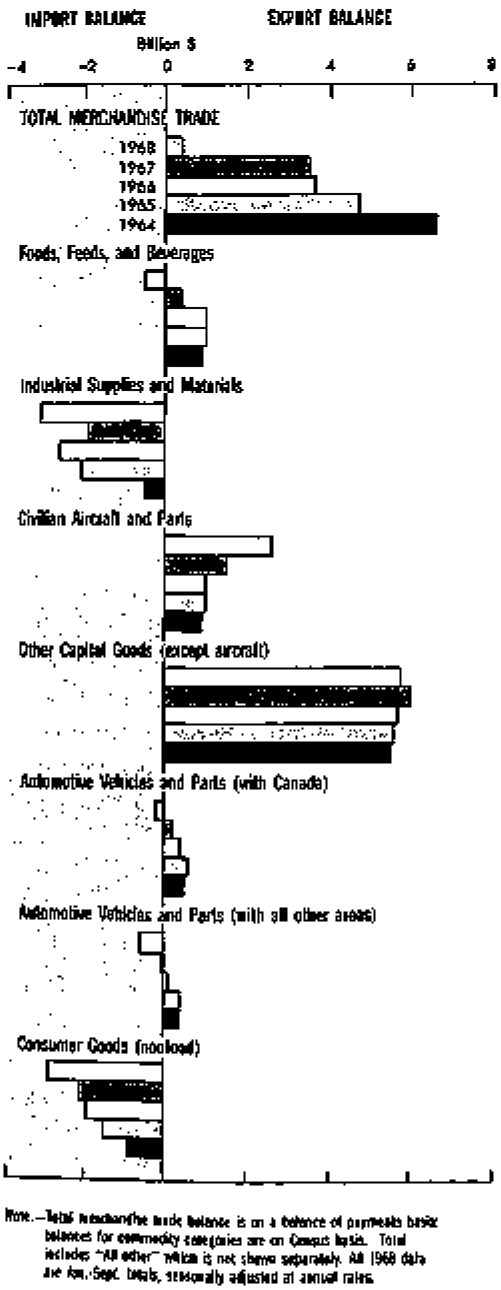
Trade surplus declines

The trade surplus, which had virtually disappeared in the first half, improved substantially in the second. However, at a seasonally adjusted annual rate of less than $1 billion (balance of payments basis), it remained extremely modest. The improvement within the year was due to a slower rate of expansion in imports. The rate of increase in imports from the first to the second half of 1968 was less than one-third as much as the 18 percent increase from the last half of 1967 to the first half of 1968. The rate of increase in exports in the last half of 1968 was comparable to the rate of increase recorded in the preceding half year.

Last year's deterioration in the trade surplus, while extreme, was a continuation of a trend dating from 1964.

Merchandise Trade Balance

Except for civilian aircraft all major commodity categories contributed to last year's deterioration



Note.—Total merchandise trade balance is on a balance of payments basis; balances for commodity categories are on Census basis. Total includes "All other" which is not shown separately. All 1968 data are Jan.-Sept. totals, seasonally adjusted at annual rates.

U.S. Department of Commerce, Office of Business Economics 69-1-21

Chart 28 indicates the persistent decline in the trade surplus during this period and shows how the decline was distributed among the broad end-use commodity categories.

In 1968, the trade surplus increased significantly only in aircraft and parts, reflecting the deliveries of jetliners to foreign airlines. The favorable balance of trade declined only slightly in other capital goods categories, but there were serious deteriorations in all other commodity groups. Automotive trade with both Canada and the rest of the world swung from surpluses to deficits, and even in the food and beverages category, the United States recorded an import surplus last year.

Private Capital and Other Transactions

The sharp decline in the merchandise trade balance from 1967 to 1968 was more than offset by the phenomenal halt to the customary net outflow of capital through private transactions. The imposition of mandatory controls on direct investment transactions at the beginning of the year and the tightening of restraints on capital outflows through U.S. banks were major factors in the unprecedented shift to a net inflow of private capital in 1968. However, the largely unrelated increase in foreign purchases of outstanding U.S. securities (mainly common stocks) was an important additional element in the improvement on capital account.

Chart 29 indicates the total net improvement in private capital transactions in 1968, by type, along with the comparable annual data since 1964. The major source of improvement last year was in foreign purchases of U.S. private securities, which were at an annual rate of $3.7 billion during the first 9 months of 1968, as compared with $1.4 billion in 1967. The sales of U.S. securities during the first three quarters of 1968 included some $1.6 billion ($2.1 billion annual rate) of bonds issued by U.S. corporations to finance their investments abroad. These sales were in direct response to the Foreign Direct Investment Program, which does not restrict transfers to foreign affiliates of funds that were borrowed abroad by a U.S. parent company. The remainder of securities sales was almost entirely foreign purchases of U.S. corporate stock—$1.2 billion during the 9 months or $1.6 billion at an annual rate.

A second major source of improvement in private capital transactions in 1968 was the reduction in U.S. bank claims of more than $400 million (seasonally adjusted annual rate) after an increase of some $460 million in such claims during 1967. This change may have reflected the tightening of the program to restrain bank credit under the Federal Reserve Program, although the total reduction in claims by the banking community was beyond that required under the program.

Additional improvement through other private capital transactions included U.S. corporate borrowing abroad from banks, largely to help finance direct investment activities. At the same time, there were some offsetting increases in corporate assets abroad other than direct investments. The greater part of these were bank deposits or other temporary investments of funds that were obtained through special bond issues or other forms of foreign borrowing.

If the transfers of funds borrowed abroad by the U.S. companies are included, the seasonally adjusted annual rate of direct investment capital outflows in the first three quarters of 1968 exceeded the $3.0 billion outflow for the year 1967. Acquisitions of existing foreign enterprises (net of liquidations of existing U.S. affiliates) totaled more than $320 million during the first 9 months of 1968 as compared with about $180 million in all of 1967. Thus, while use of foreign-borrowed funds offset a large portion of the balance of payments impact of investment activities, the actual transfers of capital for direct investment purposes were not reduced, and the Foreign Direct Investment Program appears to have had little or no adverse effect on the scope of investment activities by foreign affiliates.

Improvement in services

The annual rate of income receipts from direct investments abroad during the first 9 months of 1968 was about 14 percent above the total for 1967. This additional source of improvement in 1968 balance of payments receipts could also be attributed to the control program since reinvestments of earnings by foreign affiliates are also subject to its limitations. Receipts and payments from tourism showed some net improvement in 1968 mainly because disturbances in Europe appear to have affected payments more than receipts, and expenditures in Canada were down as compared with those of the year before, when Expo '67 attracted many U.S. visitors. Among other major payments, military expenditures abroad continued to increase and were at an annual rate of $4.5 billion in the first 9 months of 1968. In summary, the net balance on transactions in services (in contrast to merchandise trade) increased from net receipts of $1.3 billion in 1967 to nearly $2 billion at a seasonally adjusted annual rate in the January-September period of last year.

Near-Term Prospects

Improvements in the U.S. balance of payments in 1968 reflect the impact of special circumstances that are not likely to be repeated this year. It will be more difficult to realize improvements in the same areas in 1969 since some of the favorable changes in capital flows were transitory in nature or were essentially one-time contributions. There was an initial gain for the balance of payments in 1968 associated with the tightening of restraints or the imposition of new controls. Even if the controls are not relaxed, in the second year of operations they are likely only to maintain the improvements already achieved. Any reduction in the reliance on foreign sources of finance for direct investment activities could be reflected in a deterioration in the balance of payments. Tight money in the United States may discourage lending to foreigners, but another large reduction in banking claims on foreigners should not be expected.

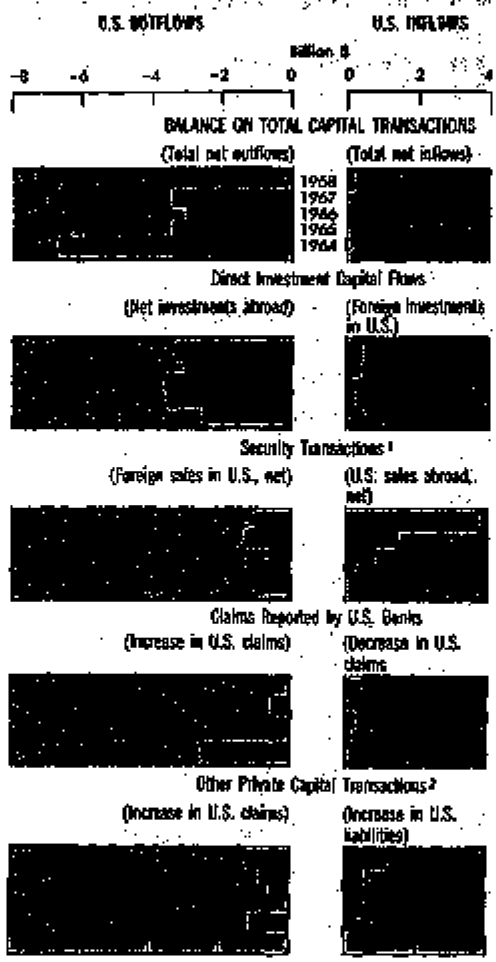
The substantial flow of foreign funds into U.S. corporate stocks could easily turn around with a sharp or prolonged decline in stock prices. But there also are reasonable grounds for expecting continued foreign interest in U.S. securities. The increasing preference among European investors for equity securities and the desire to diversify portfolios may help sustain the demand for U.S. corporate stocks. The general growth in European capital markets and the increased activity of U.S. investment firms abroad facilitate the channeling of foreign investors' demand to U.S. securities.

However, these potentialities do not alter the precarious nature of the balance of payments improvements in 1968, and the prospects are highly tenuous for future improvement in the same areas. Consequently, the outlook for even short-term gains depends upon better performance on trade account. The prospects here appear at least moderately encouraging; there is already some evidence of a slowing down in the excessively rapid growth of imports. The increase in imports of industrial supplies and materials is likely to taper off with a change in the tempo of U.S. economic activity. On the other hand, it is less likely that the persistent increase in the trade deficit in consumer goods can be reversed unless new efforts are made to counter foreign competition in major items. The rising favor among U.S. consumers for the types of goods produced abroad and the rising capacity of foreign suppliers to produce for the U.S. market make it difficult to counter the unfavorable trend in the trade balance in consumer goods. However, if the rate of growth in exports can be maintained and if imports grow less rapidly with the slowing of U.S. economic expansion, there should be considerable improvement in the foreign trade surplus in 1969.

CHART 29

Private Capital Transactions

The halting of private net capital outflows in 1968 was the major source of improvement in the balance of payments



Note.—All 1968 data are Jan.-Sept. totals, seasonally adjusted at annual rates.

1 Excluding liquidations of U.S. securities by the Government of the United Kingdom and investments by international and regional organizations in the U.S. Government agency bonds.

2 Excluding changes in U.S. liquid liabilities and special transactions by U.S. and foreign official and international agencies.

U.S. Department of Commerce, Office of Business Economics 69-1-29